Global Macroeconomic Monthly Review

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Key Issues and Table of Contents

Leumi Global Economic Forecast, As of July 2021

	2018	2019	2020E	2021F	2022F
GDP – Real Growth Rate					
World	*3.5%*	*2.6%*	*-3.1%*	*5.7%*	*4.2%*
USA	*3.0%*	*2.2%*	*-3.5%*	*6.0%*	*3.7%*
UK	*1.3%*	*1.4%*	*-9.9%*	*5.8%*	*5.5%*
Japan	*0.6%*	*0.3%*	*-4.7%*	*2.2%*	*2.9%*
Eurozone	*1.9%*	*1.3%*	*-6.7%*	*4.3%*	*4.3%*
South East Asia (ex. Japan)	*5.1%*	*4.4%*	*-4.1%*	*4.2%*	*4.8%*
China	*6.6%*	*6.1%*	*2.3%*	*8.5%*	*5.5%*
India	*6.5%*	*4.1%*	*-7.4%*	*10.4%*	*5.2%*
Latin America	*0.8%*	*-0.5%*	*-7.0%*	*5.1%*	*2.9%*
Israel	*3.5%*	*3.4%*	*-2.6%*	*5.2%*	*4.8%*
Trade Volume, Growth (%)					
Global	*3.8%*	*0.2%*	*-8.1%*	*8.0%*	*5.6%*
Interest rates, Year End					
US Fed	*2.25-2.50%*	*1.50%-1.75%*	*0.00-0.25%*	*0.00-0.25%*	*0.00-0.25%*
Bank of England	*0.75%*	*0.75%*	*0.1%*	*0.1%*	*0.1 %*
Bank of Japan-Policy Rate	*-0.07%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
ECB-Main Refi	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*
Israel	*0.25%*	*0.25%*	*0.1%*	*0.00-0.25%*	*0.00-0.25%*

The Global Economy – Overview

Economic activity: Economic activity continues to recover, but rising morbidity in developed countries may halt continued growth. In developing countries, there has been a slowdown in the recovery, and in some it has even halted by the spread of the disease.

- Global economic activity continues to recover, despite rising morbidity in a number of countries, against the backdrop of low morbidity in the US and Europe's major economies. The global PMI is at a very high level (the manufacturing index is at 57.5 points and the services index at 55.5 points), indicating continued growth in GDP and services in June, but at a more moderate pace (see Chart 1). However, the increase in morbidity in a number of developed countries, especially in Britain, Netherlands, Greece, Spain, and Portugal, as well as an apparent increase in morbidity in the US and Germany, brings into question the degree of effectiveness of the vaccination, and the duration of the vaccine. These questions are especially notable since a substantial portion of the populations in these countries has been vaccinated. In the event the vaccinations will turn out to be less effective, and/or the duration of the vaccines will turn out to be short-lived, this may lead to a renewed tightening in COVID restrictions and will most likely slow the recovery in economic activity.
- Britain's GDP increased 2.3% in April (m/m) against the backdrop of the opening of the economy, which led to a rise in private consumption. Economic growth in May was more moderate as GDP increased 0.8% (m/m), which left GDP at 3.1% below the level from February 2020, prior to the crisis. The bulk of growth stemmed from the sectors that were directly affected by the renewed opening of the economy, such as accommodation services and restaurants. Retail sales fell slightly in May, by 1.4% (m/m), after increasing 9.2% (m/m) in April, as food sales declined 5.7% (m/m), which likely indicates a shift in the expenditures of consumers from food purchases in retail stores to restaurants, pubs, and hospitality venues outside the home with the continued opening of the economy.
- Due to the sharp rise in sales in March-April, retail sales reached a level 9.3% above that from year-end 2019, prior to the crisis, which indicates the difficulty of a continued sharp rise in retail sales. The composite PMI of Britain declined in June from the peak it had reached in May, yet it remains at a high level of 62.2 points, thus indicating continued economic growth, albeit at a more moderate pace. In our view, even if the rise in morbidity will not lead to a renewed tightening in COVID restrictions, the GDP will return to its pre-crisis level only in the final quarter of this year.
- In the event the rise in morbidity will be accompanied by a rise in severe cases and in mortality, then the restrictions on economic activity are expected to return, which is likely to hamper the recovery in local economic activity. We note that the prime minister of Britain decided to carry on with the plan to remove the COVID restrictions despite the recent rise in morbidity. Britain initially took a similar approach of not imposing restrictions until after it realized the extent of the morbidity. In the event the vaccines turn out to provide insufficient protection from the virus, it is likely the COVID restrictions will be re-implemented at a relatively late stage, such that they are likely to be more aggressive and more longstanding.
- In Japan, high morbidity led to the state of emergency in the country remaining in place throughout most of the second quarter (such that the Olympics, an important economic event,

will occur without audiences). Consequently, retail sales in Japan fell in April-May, which is expected to weigh on the recovery in economic activity in the second quarter of the year. This decline is occurring following a 1.0% contraction (q/q) in Japan's GDP in the first quarter of the year. The decline in first quarter GDP was caused by the state of emergency declared in the country against the backdrop of the rise in morbidity and slow pace of vaccination of the population, which led to a decline in private consumption, foreign investments, and government expenditures.

- Japanese industrial production fell 5.9% in May (m/m), apparently due to a shortage in the supply of intermediate goods used in manufacturing. However, manufacturers are forecasting a recovery in the market in the coming months and a return to a path of growth, against the backdrop of expectations for an easing in the existing supply-side shortage. Japan's composite PMI increased slightly in June, due to an increase in the services index that offset the decline in the manufacturing PMI, yet it remains at a low level similar to that in May. The decline in the manufacturing index indicates the growth in this sector is expected to be weak until there will be an easing in the existing supply-side shortage. In our view, economic activity is expected to return to recovery later in the second half of the year, with the vaccination of a sizeable portion of the population and the halt in the spread of the coronavirus.
- In Australia, retail sales increased 0.4% in May (m/m), rising to 12% above the pre-crisis level. This increase in sales occurred despite the shutdown imposed in the state of Victoria that led to a decline in sales in that state that was more than offset by the rise in sales in Queensland and in Western Australia. However, tightened restrictions across broad portions of Australia against the backdrop of the rise in morbidity due to the spread of the Indian variant are expected to lead to a decline in retail sales in June. Nonetheless, we estimate sales in the second quarter will still be greater than the level of sales in the first quarter.
- Economic growth moderated in developing countries against the backdrop of a rise in morbidity, and in some countries the recovery even halted. In China, retail sales continued to increase in April-May and also industrial production growth continued during these months, albeit by a more moderate rate. The composite PMI of China fell in June, indicating a substantial moderation in the growth of services, coupled with a slighter moderation in manufacturing. This comes against the backdrop of a tightening in restrictions in some of the regions of China in which there has been a rise in morbidity and against the backdrop of supply bottlenecks that are weighing on the continuation of the recovery alongside the increase in demand.
- In India, the rise in morbidity in the first half of the second quarter of 2021, which peaked in May, led as well to a tightening in economic restrictions that caused contractions in industrial production in April-May, of 13% and 8% (m/m), respectively. India's composite PMI fell in June to its lowest level since August 2020, and indicates a contraction in services, alongside a more moderate contraction in manufacturing. In our view, India's GDP will contract in the second quarter by 5% (q/q), a rate that is substantially less than the decline in GDP in the second quarter of 2020, during the first wave of the virus, at which time GDP contracted by 26% (q/q). With the opening of the economy following the halt in morbidity, which is already trending downward since the second half of May, GDP is expected to recover quickly. However, a rapid opening such as that occurring now will also increase the risk for a renewed

spreading of the virus throughout the country, while most of the population remains unvaccinated, and this may lead to the reintroduction of economic restrictions later on.

- In Poland, retail sales increased 6.1% in May (m/m) with the easing in the COVID restrictions that led to the contraction in retail sales in April. However, growth in manufacturing is continuing at a moderate pace. In our view, Poland's GDP will return in the second quarter of this year to its pre-crisis level, and is even expected to continue to increase in the coming months against the backdrop of expectation for continued strong growth of the services sector.
- The rise in morbidity in the larger economies of South America, in which most of the population remains unvaccinated, is hampering economic activity. In Brazil, where morbidity is at a peak level from March, with a slight decline in the beginning of July, industrial production increased slightly in May (see Chart 2) despite the decline in the production of intermediate goods that apparently stemmed from the existing global supply-side shortage. This comes after it contracted in February – April by a cumulative rate of 4.7%. Preliminary indicators show a continued recovery also in June; however, in the event the morbidity will remain at peak levels, this will hamper growth in activity over time. In Mexico, industrial production contracted slightly in April (-0.2% m/m) after having increased over recent months, yet it increased 0.1% (m/m) in May. The rise in consumer and business confidence alongside the rise in the PMI of Mexico in June indicates a continued recovery in economic activity throughout the second quarter. However, the rise in morbidity in the second half of June is likely to weigh on the continuation of the recovery during the third quarter of the year.
- Latin America is being very adversely affected by morbidity. In Argentina, morbidity increased in April-May and led to a contraction in industrial production in these months by 1.9 and 5.0% (m/m), respectively. However, the downtrend in morbidity from the second half of May indicates the government has succeeded to halt the spread of the virus through the implementation of tightened restrictions, which will enable the economy to return to a path of growth later on with the continuing decline in morbidity. In Columbia, morbidity has been in an uptrend since the second half of March and in June it reached a peak. However, the government decided to ease the restrictions due to the heavy economic price inflicted on the country, coupled with complaints from the public against the tightened restrictions. In our view, the lifting of the restrictions is likely to intensify the morbidity in the country, which is expected to in turn intensify the health crisis there. The morbidity in Brazil is at a very high level and there are still no signs of any improvement.

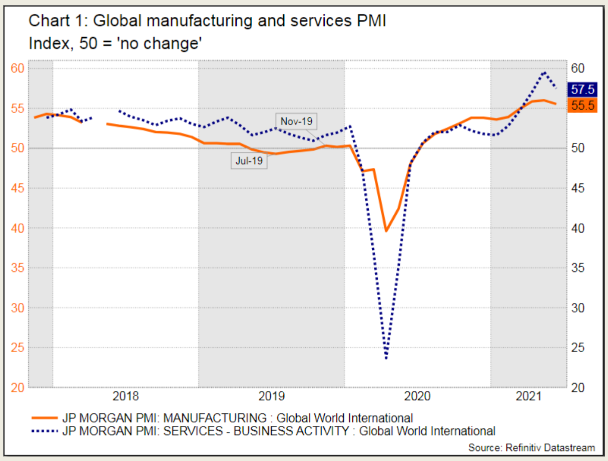


Chart 1: Global manufacturing and services PMI

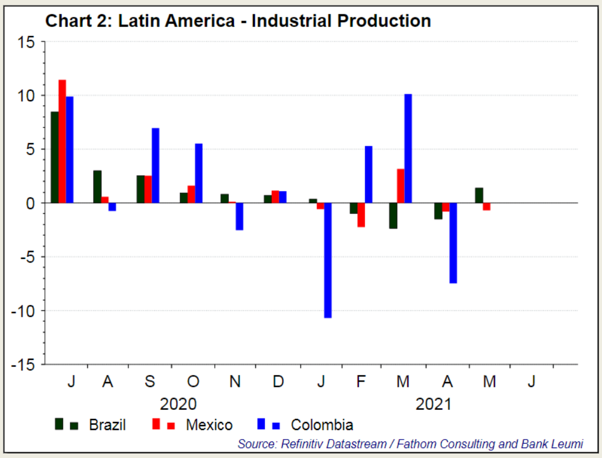


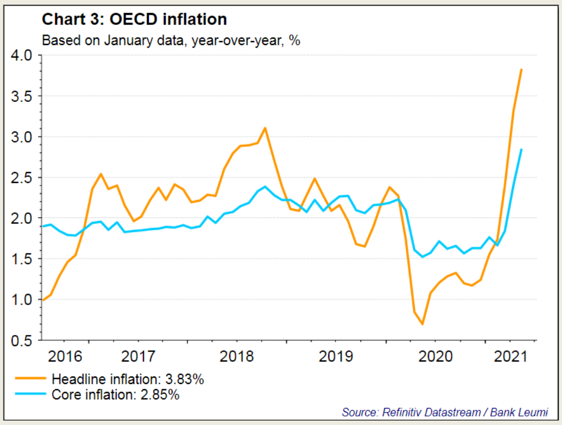
Chart 2: Latin America - Industrial Production

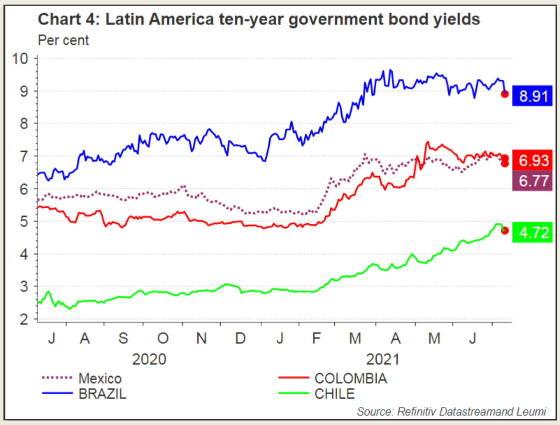
- Looking ahead, the spread of morbidity in the developed countries in which a substantial portion of the population is vaccinated brings into question the effectiveness of the vaccinations. In the event they will not succeed to halt the rise in serious morbidity and in mortality, the situation will lead to a renewed tightening in COVID restrictions, which will hurt any recovery in economic activity later on. We estimate global GDP will increase this year by 5.7%, and by 4.2% in 2022, while the US and the euro bloc will increase this year by 6.0% and 4.3%, respectively. Economic growth in China and India this year will be by rates of 8.5% and 10.4%, respectively.

Inflation and monetary policy: Inflation in developed countries increased in May and remained high in June. A number of banks in emerging markets have begun to raise interest rates. In Australia, the central bank reduced its asset purchases and hinted at an initial rate hike in 2023.

- Annual inflation in developed countries remains high. Inflation in the US increased to 5.0% in May and in the euro bloc it fell slightly in June but remained at a high level of 1.9%. The annual inflation rate in the OECD increased to 3.8% (see Chart 3) due to an increase in the energy components by the highest rate since September 2008, and the rise in housing prices by a more moderate rate compared to the preceding month. The increase in these components, with an emphasis on energy, stems mainly from the fact that in the corresponding period last year prices were very low due to the effects of the coronavirus. Annual core inflation in the OECD (excluding food and energy) also rose, reaching 2.9% in May, the highest rate since August 2002.
- The central bank of Hungary increased its interest rate by 30bps to 0.90%, which is the level this rate was at from mid-2016 up until the start of the crisis. This rate hike is intended to reduce the inflationary pressures that reached 5.1% in April-May in annualized terms, thus in effect the bank began to tighten its expansionary policy. The tightening of monetary policy comes against the backdrop of expectations for continued growth in economic activity, alongside a continued rise in inflation over the coming period. In our view, if growth remains strong and the inflation rate remains high, especially if the inflation rate remains above the central bank target (2-4%), further interest rate hikes are possible during the second half of the year.
- The central banks of Mexico and the Czech Republic have also hiked their interest rates and joined the moves of Brazil and Russia in tightening monetary policy. This comes against the backdrop of fears of a continued rise in the inflation rate. In our view, the next interest rate hikes may be in the coming months in countries with relatively advanced economies, such as South Korea, and they may focus on inflation and financial risks. Furthermore, in Columbia the rise in inflation beyond the target, coupled with the budgetary and political risks in the country, has raised the chances for an interest rate hike soon by the central bank, and even South Africa may raise interest rates if the currency continues to weaken along with the continued rise in inflation. Similarly, if global risk appetite declines, then the currencies of some emerging economies will continue to weaken, which could lead the Turkish central bank to consider raising its interest rate. Such a move would be contrary to the position of the president of Turkey who seeks a reduction in interest rates in the country.

- In Australia, the central bank has remained dovish. In the interest rate decision in early July, the bank decided to reduce the volume of government bond purchases from AU$5bn to AU$4bn per week, noting that this pace of purchases will remain at least until November. The decline in the pace of purchases is occurring against the backdrop of a rapid strengthening of economic activity and in the labor market, but the bank remains pessimistic about wage growth and rising inflation and noted that their rise is expected to be "modest and gradual". The central bank changed the wording of the statement regarding the expectations for no change in the interest rate, and it appears the bank is preparing the groundwork for raising interest rates in 2023, contrary to what was expected until recently that the interest rate will not rise before 2024.
- Yields on the government bonds of the US and the larger economies of the euro bloc fell in the beginning of July, in continuation of the decline seen in recent weeks. This indicates the markets estimate the ECB is not expected to tighten monetary policy, particularly after changing its monetary policy strategy regarding the inflation target. Also, the Fed is not expected to hike its interest rate in the near-term. This comes against the backdrop of concerns over a renewed spreading of the coronavirus that is likely to lead to a renewed tightening in COVID restrictions and damage to economic growth. In Latin America, yields remained at a high level against the backdrop of the rise in inflation, while in Chile yields increased during June (see Chart 4) following the rise in inflation, the central bank's rate hike and indications that further hike will be needed.



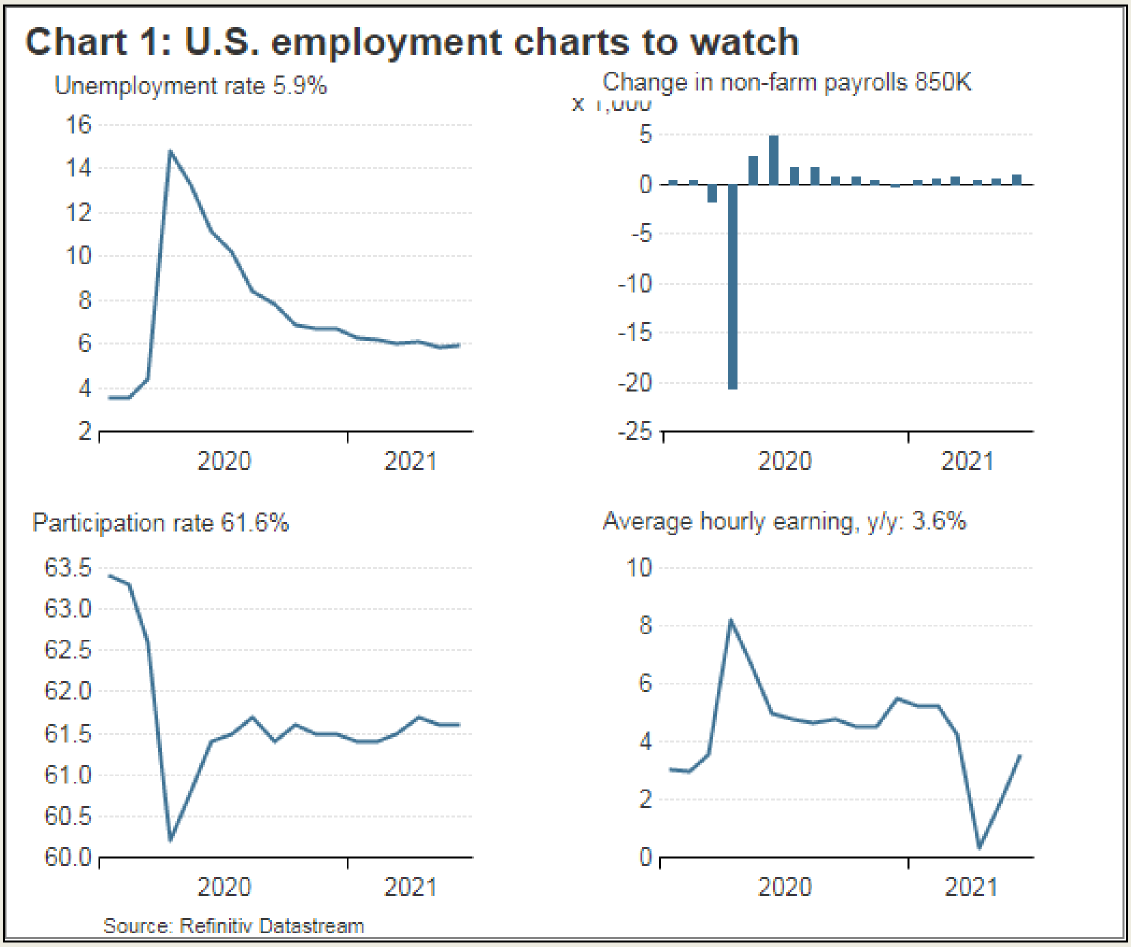


United States

Economic activity: The labor market is strengthening mostly in the sectors affected by the continued opening of the economy. Durable goods orders continued to rise due to an improvement in the transportation sectors (aircraft and automobiles). Industrial manufacturing increased in May by a moderate rate due to existing supply side shortages, while preliminary indicators show growth at an accelerated pace down the road.

- Economic activity in the American market continues to recover, as expressed in the rise in the consumer confidence index, which indicates cautious optimism among households, against the backdrop of the continued opening of the economy and the return of economic activity. The labor market continues to recover and in June a stronger-than-expected increase of more than 850,000 jobs was registered (see Chart 1).

- The improvement in employment occurred mainly in the areas mostly affected by the continued opening of the economy and the return of economic activity, with emphasis in the realms of leisure and accommodation, education, and retail trade. This increase likely signals an improvement in the temporary shortage of workers, against the backdrop of the reduction in enhanced unemployment benefit payments in some states throughout the US. However, the rise in the workforce, equaling only 150,000 persons, together with the existing gap in the workforce participation rate compared to the pre-crisis period, indicates there are still difficulties in the market. These changes in the market led the unemployment rate to rise in June from 5.8% to 5.9%. At the same time, the number of unemployed who voluntarily resigned from their previous places of employment and started to search for new work increased. This development indicates a change in the market and shows the desire of workers to find better employment with improved conditions in light of the worker shortage in the market. In our view, this process is expected to lead to a continued accelerated rise in wages and to weigh on profitability growth of companies in the future.
- Durable goods orders increased 2.3% in May (m/m), mainly due to an increase in commercial aircraft orders, which reflects the recovery in the air travel sector. Orders of transport vehicles increased 7.6% (m/m), while motor vehicle orders increased 2.1% (m/m), similar to the rise in industrial manufacturing, and commercial aircraft orders increased 27.4%. Durable goods



orders excluding transportation increased by a low rate of 0.3% (m/m) while non-defense capital goods orders fell 0.1% (m/m). We note that orders remain at a high level and the weakness in May appears temporary. In our view, an increase is expected in investment in business equipment, mainly in data processing systems and equipment, in the data for the second quarter of 2021, particularly against the backdrop of the improvement that has occurred in the realm of international and local shipping, which weighed on growth.

- Industrial manufacturing continued to grow in May at a moderate rate, due to the existing supply side shortage. Preliminary indicators show continued manufacturing growth, despite the existing shortage in the supply side, and this growth is even expected to expand as this shortage passes. The ISM index fell slightly in June yet remains near its high level, indicating continued economic growth. The index indicates on-going pricing pressures that are leaving inflation at its high level, due to the existing supply side shortages that are expected to continue to affect the market in the coming months. The PMI for June indicates strong manufacturing growth as well, alongside continued growth in services at a more moderate rate than that in May.
- New home sales declined 5.9% in May (m/m), reaching the lowest level in the past year. However, the expected decline in lumber prices later in the year is expected to support an increase in construction starts over time. The low inventory of housing units weighs on the housing market and the number of existing home sales fell in May to an 11-month low. At the same time, rising housing prices and increasing mortgage rates are hampering the ability of households to purchase homes, which is likely to hurt demand. However, we estimate that in the short-term the effect of supply shortages is expected to be stronger.
- The updated forecast of the Congressional Budget Office (CBO), which takes into consideration also the American rescue plan, indicates that US federal debt will rise from the current level of US$22.3tn to US$35.8tn by the end of 2031, while the increase will occur also in terms of percentage of the GDP. The budget deficit this year is expected to amount to US$3.0tn (13.4% of GDP) and cumulatively the deficits in 2021-2031 are expected to be US$0.6tn higher than in the past. Federal expenditures in the coming decade are expected to average 22% of GDP, compared to an historic average of 20.6% of GDP, and revenues in the coming decade are expected to average 17.8% of GDP, compared to an historic average of 17.3% of GDP.
- Looking ahead, the growth in economic activity is expected to continue against the backdrop of the downtrend in morbidity, which is at a low level. This situation enables economic activity to continue to return to normal. In our view, GDP is expected to grow this year by more than 6%, rising above the pre-crisis level. However, the renewed outbreak of the Indian variant of the virus around the world represents a risk to the growth forecast in the event this outbreak will occur also in the US.

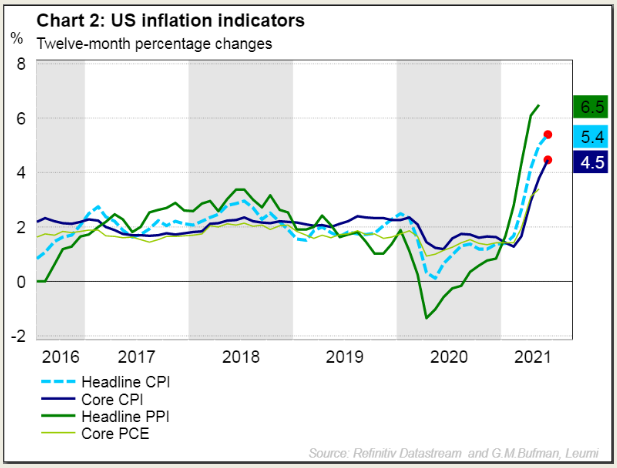
Inflation and monetary policy: The Fed is optimistic regarding growth expectations and it declared it will extend for a final time the Paycheck Protection Program Liquidity Facility (PPPLF). The Fed has launched a tool that will help small banks cope with the

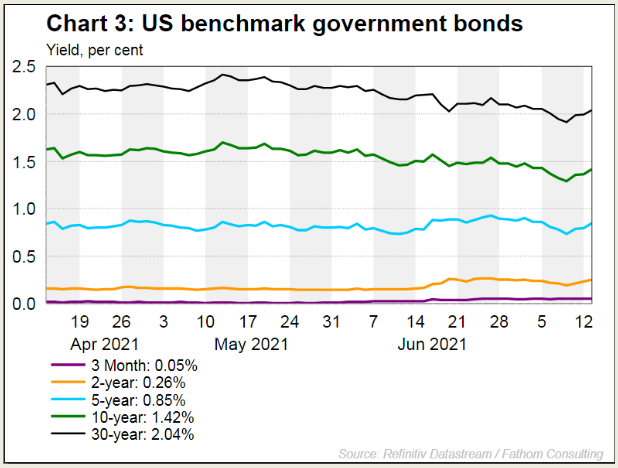
change in the way credit losses are recognized. Over the past month, bond yields have continued the downtrend that has characterized the market for months due to the decline in real interest rates and the Fed's intervention in the market.

- The Fed remains optimistic regarding expectations for the recovery in economic activity and it estimates that together with the expected strong growth this year and in 2022, the unemployment rate will fall in 2022 to below the long-term unemployment rate. These expectations led the Fed to declare that the extension in the PPPLF to the end of July 2021 will be the last extension. This facility was launched at the start of the crisis in order to supply liquidity to the banks and other financial institutions, with the goal of increasing the amount of credit supplied to small businesses. This announcement indicates the Fed has started to reduce its massive support for the market, which is expected to be expressed later on also in a narrowing of its expansionary monetary policy. This comes despite the fact that in the June press conference the Chairman of the Fed claimed the Fed is far from achieving its employment and price stability targets, to a sufficient enough degree that will lead to a change in the expansionary monetary policy and a reduction in asset purchases.
- The minutes from the FOMC June meeting show that the committee members were not hawkish despite the rise in inflation, and for now the median forecasts of the committee members indicate that the interest rate in 2022 will remain unchanged, while in 2023 two rate hikes are expected of 25bps each. In addition, it appears there is still no widespread support for initiating a procedure to reduce the Fed's asset purchases and that committee members believe the Fed should be more patient about announcing a change in its asset purchasing policy. Some members noted the conditions for initiating any policy change may materialize faster than the committee's expectations at their May meeting. In addition, at the conclusion of the discussion on asset purchases it was agreed that at upcoming meetings the committee members will continue to monitor the developments in the market and the progress toward the Fed's employment and inflation targets.
- In the semi-annual testimony on policy by the Fed Chair Jerome Powell, the main message remains that most of the increase in inflation is due to transitory factors, which in the Chairman's view are mainly due to production bottlenecks or other supply constraints. In his view, inflation will remain elevated in coming months, but it likely to start to reverse soon. In the light of the upside risks to the Fed forecast that core PCE inflation will be 2.1% in 2021, Powell said that the FOMC "would be prepared to adjust the stance of monetary policy as appropriate if we saw signs that the path of inflation or longer-term inflation expectation were moving materially and persistently beyond levels consistent with our goal".
- With regard to the labor market, Powell said that the labor shortage is putting upward pressure on wage growth and inflation expectations. However, the outlook for real economic growth weakening and the Fed still focused on its "broad and inclusive" full employment goal, which means that the rise in inflation is not expected to lead to a tightening of monetary policy. We note that this reference to the employment goal supports the approach that the quantitative purchases may not be tapered until early next year and the interest rate will increase at a later stage, probably in the first half of 2023.

- The Fed has launched on July 15th a tool that will help small community banks (banks with total assets of less than US$1bn) to cope with the required accounting requirements resulting from changes in the rules regarding the recognition of credit losses. In June 2016, the Financial Accounting Standards Board (FASB) in the US changed the manner of recognizing credit losses, while the new approach is in accordance with the Current Expected Credit Loss (CECL) model, which requires to estimate the expected losses over the life of the loans and recognizing immediately any credit losses. This standard has consequences for the financial reports of credit providers and is coming into effect gradually, with small banks required to change their approach in calculating credit losses in the beginning of 2023.
- The inflation rate continued to rise for four consecutive months. The consumer price index (CPI) increased in June to an annual rate of 5.4%, and the core component increased to 4.5%, the highest since 1992 (see Chart 2). The bulk of the increase was concentrated in the components affected by the continued opening of the economy and the return of economic activity. The recovery in tourism resulted in a 2.7% (m/m) rise in airfare and a 7.0% increase in hotel room rates. The temporary shortages on the supply side, mainly semiconductors which affect the automotive industry, contributed to the rise in inflation. New vehicle prices and used vehicle prices increased by 2.0% and 10.5% (m/m) respectively. Signs of inflationary pressures exist also in the housing market, against the backdrop of the low housing inventory, and in the restaurant sector due to lack of employees.
- These price pressures are likely to remain for some time in the US against the backdrop of labor shortages that may lead to wage pressures in many sectors. In our view, the inflation rate (December/December) will rise well above 4% in 2021, and in 2022-2023 the average inflation rate will be higher than the average target of 2%. The producer price index increased in the last five months, reaching in May 6.5% in annualized terms, the highest rate since 2009. This is due to existing supply side shortages.
- Long-term US government bond yields declined in June and the beginning of July, in continuation of the downtrend that started at the end of the first quarter of the year (see Chart 3). This is the result of the decline in the long-term real interest rate, coupled with the continued asset purchases of the Fed that more than offset the impact of the expectations for a rise in inflation. It appears the decline in the yield-to-maturity rate reflects the market estimates regarding the start of interest rate hikes by the Fed in 2023, yet at a relatively low terminal level. In other words, the market is indicating that the once the Fed funds rate starts to rise, it's total increase will be limited. This may be an indication of the market's apprehension of a renewal of Covid related constraints and a limited recovery of economic activity with a substantial slowdown in growth rates in coming years. Moreover, the market seems to now be increasingly convinced that the sharp rise in inflation is temporary and should not be reflected in longer term inflation expectations.
- According to the US Congressional Budget Office (CBO), the yields-to-maturity of 10-year US government bonds are expected to climb in 2022 to 1.9% and to average 2.8% in 2022-2031. We estimate the current level of yields is approximately 100bps below the level they would be at without the Fed's intervention in the market. A continued recovery in economic activity is expected to lead to a decline in the unemployment rate and inflation is expected to

remain near the target level or slightly above it. Consequently, the Fed's intervention in the market is expected to decline and yields are expected to climb.





The Euro Bloc

Economic activity: Euro bloc economic activity is recovering, which has led to an increase in retail sales and a strengthening labor market. Preliminary indicators show continued strong growth of manufacturing and services; however, a rise in morbidity, in the event this occurs, is likely to hamper growth.

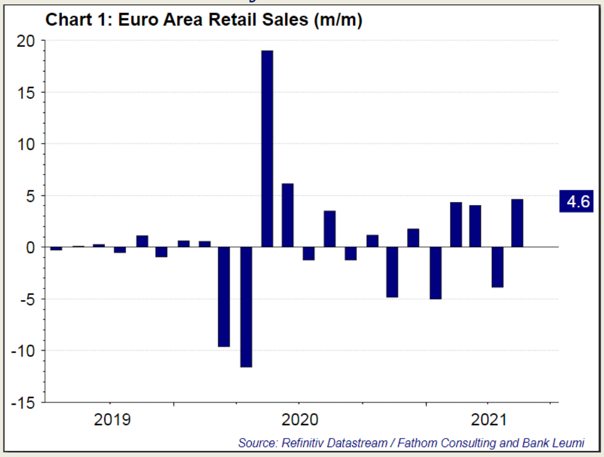
- Euro bloc economic activity is recovering, with the continued opening of the economy. Consumer confidence continued to climb in May-June, reaching its highest level since January 2018, thus indicating a rise in optimism among households against the backdrop of the fall in morbidity and the continued opening of the economy. Retail sales increased 4.6% in May (see Chart 1), more than offsetting the fall that occurred in April, thus suggesting a rapid recovery in the services sector. However, there appears to have been an uptick in morbidity in France and Spain, a development that is likely to return pessimism to the market in the event the spread of morbidity will strengthen.
- The euro bloc labor market continues to recover, as expressed in the downtrend in the unemployment rate, which fell in May from 8.1% to 7.9% (see Chart 2) due to the renewed opening of many components of the services sectors. This development led to a broad recruitment of workers, and a continued rise in the costs of employing workers in the first quarter of the year. The rise in the average hourly wage moderated during the first quarter, increasing by 1.5% during the quarter (y/y), the most moderate rate of increase since year-end 2016, after it had increased 2.8% in the final quarter of 2020 (y/y). In our view, wage growth will be moderate in the coming years, which is expected to lower inflationary pressures from salaries later on. Furthermore, the unemployment rate is expected to continue to decline despite the expected halt in government support for the labor market. This is dependent on the return of workers to the workforce and the pace of the return of employees that companies had furloughed throughout the crisis.
- Preliminary indicators show a continued recovery in local economic activity during the second quarter of the year. The Economic Sentiment Indicator (ESI), a composite indicator

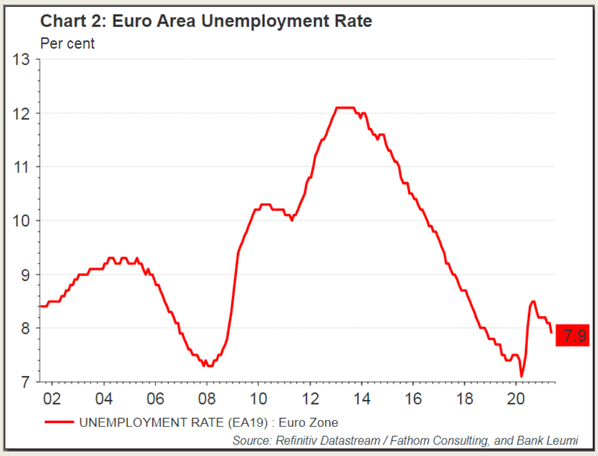
of euro bloc business sentiment produced by the European Commission, increased in June, showing positive sentiment in the market, with the continued opening of the economy and the return of economic activity, and a strong recovery at the end of the second quarter. The index indicates that existing supply side shortages are hampering manufacturers in the market, yet we estimate that in the coming months supply levels will return to normal and economic activity will continue to grow. The composite PMI of the euro bloc continued to climb in June, led by the rise in the index of the services sectors, which increased from 55.2 to 58.3 points. The index indicates continued growth of economic activity at a rapid pace, and at the same time pricing pressures are also starting to affect the market. The manufacturing sector PMI increased slightly as well, reaching a record level of 63.4 points, indicating that the existing supply side shortages have not substantially affected growth of manufacturing activity.

- In Germany, the decline in automobile production is weighing on industrial production and led to its decline of 0.3% in May (m/m). This decline is occurring despite strong demand in the market and it stems from a shortage in semiconductors that is hampering the recovery in supply. In our view, the recovery of the automobile sector is expected to be gradual, yet the growth of other manufacturing excluding the automobile sector is expected to remain strong. The IFO business climate index for Germany increased in June due to an improvement in market conditions and in the expectations of businesses, and the index points to continued economic growth in the second quarter and in the coming months, with an emphasis on the services and retail sectors. The composite PMI index of Germany increased in June from 56.2 to 60.1 points, indicating continued growth in economic activity in both manufacturing and services. The bulk of the increase derives from an increase in the services index, which rose by five points to 57.50 points, but also the manufacturing index increased slightly, remaining at a high level. These indices are based on surveys that were conducted throughout June. However, recently there has been an uptick in morbidity in Germany, reflected in a rise in the number of new daily infections, while there are signs that the high morbidity is actually greater than the official data indicate. This concern is based on the high mortality rate relative to the number of new infections over the last month, equaling approximately 6%. This rate is substantially higher than the mortality rate during this period in other developed countries that reliably collect morbidity data, and is also substantially higher than the mortality rate from the virus in Germany from the beginning of the virus outbreak in February 2020 that stood at only 2.5%.
- The manufacturing sector continues to strengthen also in Italy and Spain. Industrial production in Italy increased at a moderate, yet stable rate from December 2020 through April 2021 (the most recent month for which data is available), despite the high morbidity that occurred throughout the first quarter of the year. Furthermore, the PMI for June indicates continued manufacturing growth, together with growth in the services sectors. In Spain, industrial production also returned to a path of growth as it increased in March-May after contracting slightly in the beginning of the year against the backdrop of the spread of morbidity at the same time it was peaking. In May, industrial production increased 4.3% (m/m), the highest rate since August 2020, thus indicating a strong recovery in this sector and the PMI for June indicates continued strong growth in manufacturing and services. In France,

industrial production fell slightly in May due to the effects of existing supply side shortages, yet the composite PMI increased in June, indicating continued recovery in activity in manufacturing and services.

- Looking ahead, the fall in morbidity, against the backdrop of the vaccination of the population, is allowing for the continued opening of the economy, and supports a strong growth in GDP. In our view, the recovery in activity is expected to continue in the second half of the year and the GDP of the euro bloc will grow this year and in 2022 by an annual rate of 4.3%. However, the rise in morbidity in some countries, and there are worrying signs of a renewed outbreak in Spain and France, is likely to hamper the continuation of recovery in economic activity.



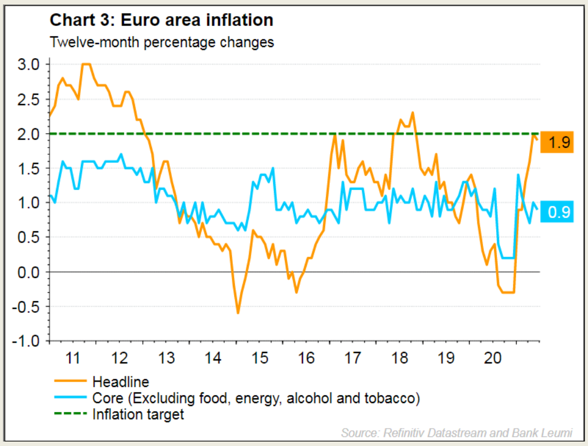


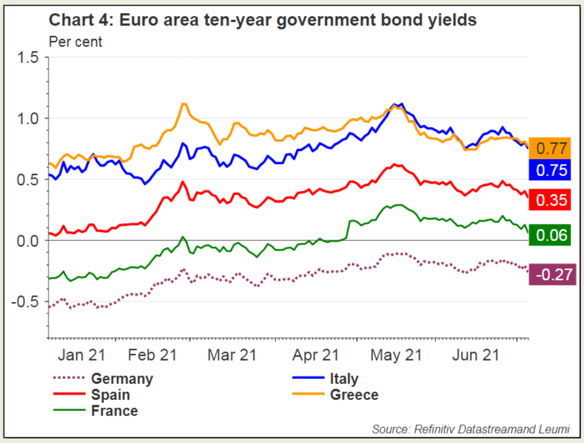
Inflation and monetary policy: The President of the ECB estimates growth will accelerate in the second half of the year and that the high inflation rate stems from temporary factors. The consumer price index of the euro bloc fell in June due to the decline in services prices. Yields-to-maturities of the main economies fell over recent weeks and the yield differential between the yields of Italy and Spain and the yields of Germany and France narrowed.

- In the June interest rate statement, the President of the ECB, Christine Lagarde, estimated the recovery in economic activity is expected to accelerate in the second half of the year. However, there is still uncertainty due to concerns over a renewed outbreak of the coronavirus, in addition to uncertainty regarding the reaction of the economy to its renewed opening. In her view, inflation stems from temporary factors that support its continued rise also in the second half of the year. Yet, as the effects of these factors fade over time, the inflation rate is expected to return to a lower rate. The ECB announced it will continue the Pandemic Emergency Purchase Program (PEPP) according to the original plan. In any event, the purchases will continue until the coronavirus crisis passes, and the central bank warned against a continued rise in market interest rates due to the negative effects of the tightening financial conditions on the rate of recovery in economic activity.

- The ECB announced a change in its position regarding the inflation target, while making it more flexible. In the past, the definition was for a medium-term target at a level close to 2%, but "from below", that is to say slightly below this level of 2%. Now the definition has changed by setting an inflation target of 2%, but not "from below", that is to say, referring to a symmetrical deviation from the target, and especially while striving for a future approach similar to that of the US Federal Reserve of an average inflation target – AIT. In this new framework, this means the ECB will allow inflation to be above 2% for a certain period, as compensation for prolonged periods of inflation below 2%. In addition, the President of the ECB noted that in setting interest rate policy the bank will also take into account the cost of owner-occupied housing as the bank relates to the euro bloc inflation rate. This is in reference to the consumer price index used in the euro bloc, the harmonized indices of consumer prices (HICP), which does not include this component. This move is in order to better represent the relevant inflation rate for households. As a result of the change in policy, it seems a future step toward monetary tightening in Europe (raising interest rates) is becoming even more distant and such a move will occur relatively late following the start of any such tightening move in the US.

- The HICP declined slightly in June to 1.9% in annualized terms (see Chart 3) after having increased over the preceding three months, reaching 2.0% in May. Part of June's decline stemmed from a drop in the core components, with an emphasis on the services components that fell and offset increase in the prices of non-energy manufactured products, which led to a decline also in the core inflation rate that fell in June from 1.0% to 0.9% in annualized terms. In our view, companies will succeed to "roll over" to the consumer at least a portion of the price increases that stem from the existing temporary supply side shortages. This development may in the short-term maintain the high inflation rate, leading to a decline in the inflation rate in 2022 with the relief of the temporary shortage.
- The yields-to-maturity of long-term government bonds of the larger euro bloc economies were in an uptrend from the beginning of the year through mid-May, but then started to decline. In the second half of June yields rose by a moderate rate, but in the beginning of July these returned to the downward trend of recent weeks (see Chart 4). The fall in yields in mid-May led to a decline in the yield curve, with an emphasis on the shorter end of the curve (3M-10Y, 2Y-10Y), and also to a narrowing in the yield differential between the yields of Spanish and Italian long-term bonds and the yields on the long-term bonds of Germany and France. This came against the backdrop of the low level of morbidity and against the backdrop of the expectations that the inflation rate will remain high throughout the coming months.





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