

# Global Macroeconomic Monthly Review

A dark blue banner with a white chevron pointing to the right. The text "October 2020" is written in white italicized font.

*October 2020*

**Dr. Gil Michael Bufman, Chief Economist**

**Bnayahu Bolotin, Economist**

***Economics Department, Capital Markets Division***

***Please see disclaimer on the last page of this report***

## **Key Issues and Table of Contents**

### **Bank Leumi Economic Forecasts (p. 3)**

#### **The Global Economy – Overview (p. 4)**

- *The recovery in global economic activity is continuing, against the backdrop of the spread of the coronavirus across the world, although the pace of recovery is expected to slow.*
- *The exports of developing countries continued to grow, but this increase is likely to slow due to the rise in morbidity in the larger economies of the world.*
- *Inflation in the OECD countries did not substantially change in August, although in Britain the annual inflation rate dropped sharply.*
- *The central bank of Turkey raised its interest rate 200bps.*
- *FTSE Russell announced it will incorporate the government bonds of China into its World Government Bond Index (WGBI).*

#### **United States (p. 9)**

- *US economic activity continued to recover in the third quarter, alongside a continued spread of the coronavirus throughout the US; in our opinion, economic growth is expected to continue.*
- *The housing market strengthened as well, as housing sales continued to increase and the new housing supply in the market fell to its lowest point in recent decades*
- *The members of the FOMC raised the economic forecast and they estimate the interest rate will remain at a near-zero level at least until 2023.*
- *Long-term government bond yields increased in recent weeks and led to a rise in the medium and longer portions of the yield curve.*

#### **Euro Bloc (p. 13)**

- *The ECB estimates it will use the total amount allocated to the Pandemic Emergency Purchase Program (PEPP).*
- *The annual rate of inflation of the euro bloc declined to a negative level of -0.3%, and core inflation fell to an annual rate of 0.2%. In our opinion, the inflation rate is expected to increase in the coming months.*
- *The recovery in economic activity within the euro bloc is continuing, while retail sales have increased above pre-crisis levels.*
- *Preliminary indicators show a slight slowdown, particularly in the services sector, due to the rise in morbidity.*

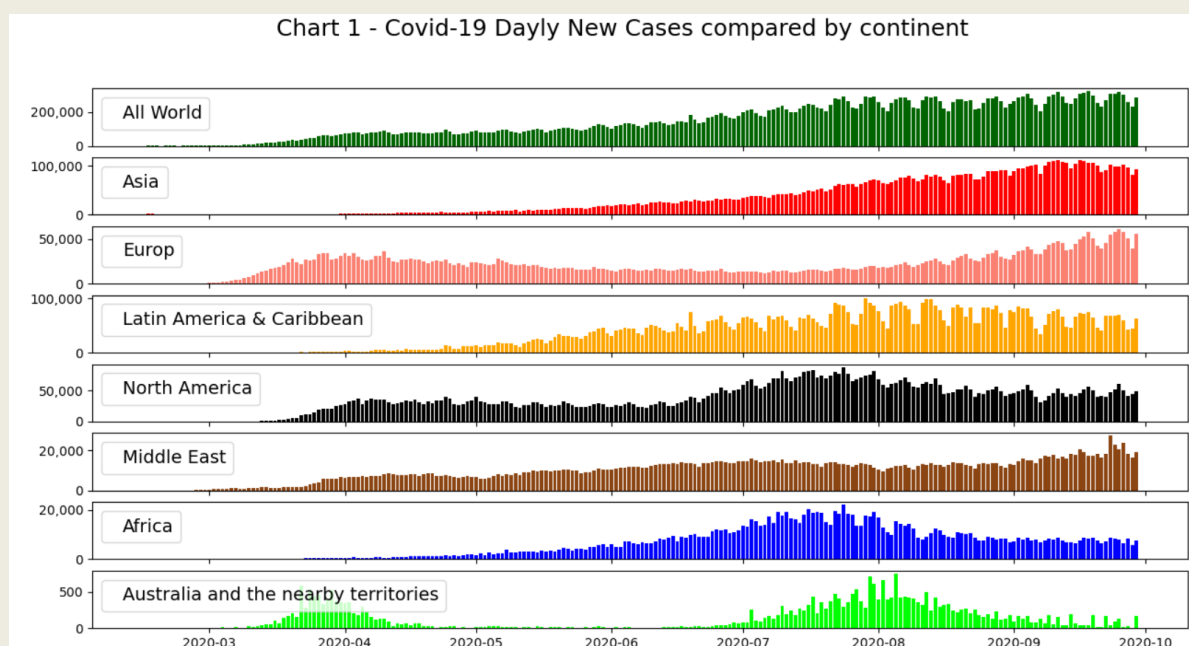
***Leumi Global Economic Forecast, As of October 2020***

	<b>2017</b>	<b>2018</b>	<b>2019E</b>	<b>2020F</b>	<b>2021F</b>
<b>GDP – Real Growth Rate</b>					
<i>World</i>	3.8%	3.5%	2.6%	-4.4%	4.8%
<i>USA</i>	2.3%	3.0%	2.2%	-5.3%	4.0%
<i>UK</i>	1.9%	1.3%	1.5%	-9.5%	6.9%
<i>Japan</i>	2.2%	0.3%	0.7%	-6.4%	1.7%
<i>Eurozone</i>	2.7%	1.8%	1.3%	-8.6%	5.4%
<i>South East Asia (ex. Japan)</i>	5.3%	5.1%	4.4%	-3.3%	4.5%
<i>China</i>	6.8%	6.6%	6.1%	1.7%	7.3%
<i>India</i>	7.0%	6.1%	4.2%	-8.5%	9.1%
<i>Latin America</i>	0.9%	0.7%	-0.6%	-8.2%	3.4%
<i>Israel</i>	3.6%	3.5%	3.4%	-5.5%	5.8%
<b>Trade Volume, Growth (%)</b>					
<i>Global</i>	5.8%	3.7%	0.9%	-16.2%	9.2%
<b>Interest rates, Year End</b>					
<i>US Fed</i>	1.25-1.50%	2.25-2.50%	1.50%-1.75%	0.00-0.25%	0.00-0.25%
<i>Bank of England</i>	0.50%	0.75%	0.75%	0.1%	0.1 %
<i>Bank of Japan-Policy Rate</i>	-0.04%	-0.07%	0.0%	-0.1%	-0.1%
<i>ECB-Main Refi</i>	0.00%	0.00%	0.00%	0.00%	0.00%
<i>Israel</i>	0.10%	0.25%	0.25%	0.00-0.25%	0.00-0.25%

## The Global Economy – Overview

**Economic activity:** the recovery in global economic activity is continuing, against the backdrop of the spread of the coronavirus across the world, although the pace of recovery is expected to slow. The exports of developing countries continued to grow, but this increase is likely to slow due to the rise in morbidity in the larger economies of the world.

- Until recently, economic activity continued to recover across the world, despite the spread of a second wave of the coronavirus in a large number of countries, which led to a slowdown in the growth rate in these economies. Global trade increased from its May lows, at which time trade contracted 17% compared to the level from December 2019, and through July global trade completed a recovery of two-thirds of the large drop registered in the first five months of 2020 and reached a level only 6.6% below the December 2019 peak. In our opinion, global trade is expected to register continued growth also in the third quarter, and in the event there will not be any general lockdowns in the larger economies of the world, because of spreading morbidity, then the level of global trade is likely to increase also in the fourth quarter of the year. Meanwhile, overall global trade in 2020 is expected to contract 16.2%; however, it is expected to increase 9.2% in the coming year.
- The spread of the coronavirus across the world is continuing (see Chart 1). In most countries, this spread represents a second wave of morbidity, while in some countries the current spread is the continuation of a first wave that has not yet faded. The main concentrations of the spread are in Asia and Europe. In Asia, the main area of concentration of morbidity is located in India. This country has the highest number of daily new infections, at almost double the number of daily infections in the US. In our opinion, in the event the rate of infection in India will not be substantially slowed, then the number of coronavirus infections in the country will overcome that in the US (it is worthwhile to remember that the population of India is four times larger than that of the US), which currently has the largest number of infections in the world. In Europe, the spread of the virus is currently concentrated in Spain, Russia, France, and Britain. Meanwhile, the spread of a second wave of morbidity in Holland is at a peak



and the daily number of new infections increased sharply last month, reaching a level double that from the peak registered back in the first wave. In Latin America and in North America the number of daily new infections has slowed, against the backdrop of a slowdown in infections in Brazil and in the US. Australia has succeeded to suppress its second wave by implementing a strict shutdown in Victoria, the country's second smallest state, which represented the central concentration of the outbreak.

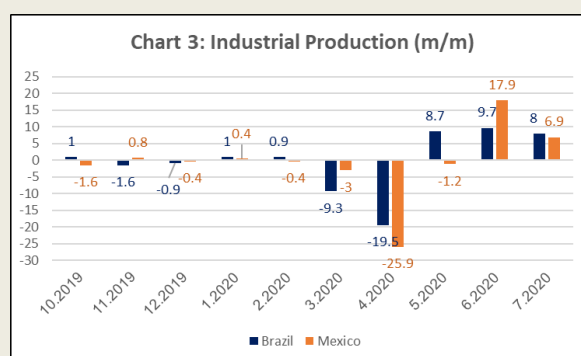
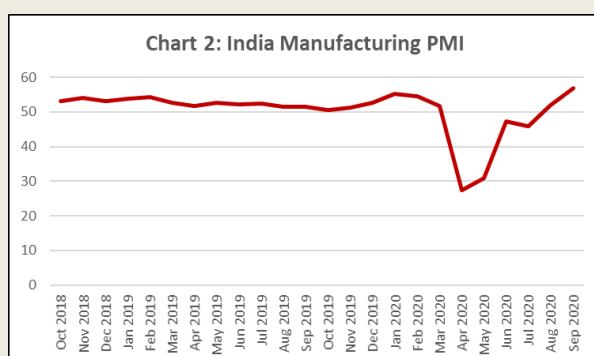
- Industrial production and retail sales increased in a substantial portion of the developing countries, and the PMI indicates continued growth in economic activity, albeit at a lower rate. Continued increasing severity in economic restrictions within many countries is likely to slow the improvement in the economic situation in the fourth quarter of the year, with even a potential deterioration in the situation. This is primarily the case in the services sectors in which a direct connection is required without any intermediary between service providers and the customers of such services (culture, entertainment, tourism, transportation, etc.). In Japan, industrial production increased 1.7% in August (m/m) and the PMI of the industrial sector increased slightly in September, yet remains at a level below 50 points, thus showing a slight contraction in economic activity of the manufacturing sector. Retail sales in Japan increased in August by 4.6% (m/m) against the backdrop of a decline in the spread of morbidity from the coronavirus. In our opinion, in the event the spread of the second wave of the virus will continue to fade, then retail sales are expected to continue to climb in the near-term.
- In Britain, GDP increased 6.6% in July (m/m), following an increase of 8.7% in June (m/m), thus indicating the GDP is expected to increase in the third quarter following the sharp contraction registered in the second quarter. Retail sales in Britain increased 0.8% in August (m/m), reaching a level 4.0% above the pre-coronavirus level. The composite PMI declined in September from 59.1 to 55.7 points, yet indicates continuing growth in economic activity. Meanwhile, the bulk of the decline in the index stems from the services sector. The decline in the index likely expresses a slight slowdown in the growth rate of each sector; however, the index still indicates growth in the economic activity of both the industrial manufacturing and the services sectors. Further to the above, the bulk of the slowdown is expected to be in the services sectors, which are directly affected by the new government imposed restrictions on activity.
- Britain announced an economic plan for the coming winter, against the backdrop of the rise in morbidity in the country, in an attempt to ease the impact of the tightening of restrictions on economic activity. As part of the changes, Britain launched its "Job Support Scheme" plan, which will be initiated in the beginning of November and will help to maintain the employment positions of workers who will be able to work at least one-third time, instead of releasing them to unpaid vacation. This has the advantage of maintaining the employee-employer relationship, with the goal of helping to maintain the business infrastructure and the human capital that has developed over time. Furthermore, Britain announced the extension of the lowered VAT rate in the accommodation and tourism sectors, which declined from 20% to only 5%, through the end of March 2021, compared to the original expiration date scheduled for mid-January. In addition, the government will permit businesses to pay their VAT liabilities in a flexible manner of up to 11 payments, and a previously announced government loan plan will be extended through December, and in addition the period of loan

re-payments will increase from six to ten years. The cost of all these measures is expected to bring total support of the British government stemming from the outbreak of the coronavirus to £200bn, which is equivalent to approximately 8.9% of GDP.

- In the developing countries, the increase in exports continued throughout July, against the backdrop of the return of global economic activity. However, this increase is likely to fade due to an expected slowdown in economic recovery against the backdrop of the continued spread of the coronavirus in the larger economies of the euro bloc, a development that is likely to reduce external demand, coupled with damage to local demand. The PMI of the developing countries declined in September and indicates a slight slowdown in the recovery of the developing economies, with this slowdown occurring also in the countries in which the number of those infected by the virus is declining.
- Industrial production in China continues to grow, increasing in August from 4.8% (y/y) to 5.6% (y/y); however, investment in fixed assets contracted 0.6% (y/y). The PMI of the industrial sector in China declined slightly in September, yet it indicates continued growth of industrial production. Meanwhile, the components involving new export orders and employment increased, thus indicating that external demand for Chinese manufacturing has not yet been hurt by the spread of the second wave of the coronavirus in a large number of countries. Retail sales increased in August from -1.1% (y/y) to 0.5% (y/y), and for the first time since the beginning of the year an increase was registered also in annualized terms, following the sharp drop in sales that occurred in January this year.
- In India, the industrial manufacturing PMI increased in September to a peak level of 56.8 points, indicating a continued recovery in industrial economic activity (see Chart 2). In addition, the deficit in India's trade of goods continued to widen in August, increasing from US\$4.8bn to US\$6.8bn, representing a return to its normal historical range. In Latin America, the growth in industrial production slowed in July in Mexico and Brazil (see Chart 3). The PMI of Brazil's industrial sector reached a peak level of 64.7 points in August, thus indicating continued growth in industrial economic activity.
- Looking ahead, according to the latest IMF estimates, global GDP is expected to contract 4.4% in 2020, and to grow 5.2% in 2021. The GDP of the advanced economies is expected to contract 5.8% this year, compared to an expected contraction of 3.3% among emerging market and developing economies. Britain's GDP is expected to contract by a very sharp rate of 9.8% this year, due to the spread of the virus in the country and the local economic shutdowns; however, the country's GDP is expected to grow 5.9% next year.
- According to the IMF estimates, global GDP expected to contract 4.4% in 2020 and grow in 2021 by 5.2%. in 2021-2025 expected average annual growth of approximately 4.1%. the IMF examine multiple scenarios, and according it estimates in the positive scenario the growth rate will accelerate and the GDP will increase approximately 5.7% in 2021 and in the negative scenario the GDP will only growth approximately by 2.2%. The developing economies will see a more negative impact then the advanced economies, due to their inability to provide broad enough fiscal support to the economy. In addition, in the negative scenario the level of GDP will not reach that of 2019 before 2026.
- The main scenario of the IMF assumes continued social distancing throughout 2021, a situation that should gradually loosen as an effective vaccine enters the market and against

the backdrop of the addition of therapeutic medications to treat the symptoms of disease. The IMF estimates that the rate of infection will be greatly reduced by the end of 2022. The main risk to the forecast is the continuation of morbidity, with significant influences on industries based on direct, person to person, contact during servicing.

- One of the consequences of the pandemic and the policy response is a significant increase in the ratio of public debt to GDP. Another result is the possibility of economic scarring, with the loss of human capital and bankruptcy of businesses and the need for structural changes and increased productivity gains in order to recover. Among the structural changes are changes in the physical characteristics of workplaces and in greater safety of employees. There will be need for vast infrastructure investments in health, education, other types of infrastructure and better protection of the environment.
- In the developed economies, the recovery is expected to slow due to the spread of the virus among the larger economies, which is likely to slow external demand, coupled with a slowdown in domestic demand. China is expected to be the sole large country that will register positive GDP growth this year. The GDP of India is expected to contract 10.3% this year, and to grow in 2021 by 8.8%, the highest expected growth rate. In Latin America, GDP is expected to contract 8.1% this year and to increase 3.6% in 2021. Meanwhile, Brazil's GDP is expected to continue to grow in the final quarter of the year and is expected to contract 5.8% in all of 2020, but is expected to increase 2.8% in 2021.



**Inflation and monetary policy:** inflation in the OECD countries did not substantially change in August, although in Britain the annual inflation rate dropped sharply. The central bank of Turkey raised its interest rate 200bps. FTSE Russell announced it will incorporate the government bonds of China into its World Government Bond Index (WGBI).

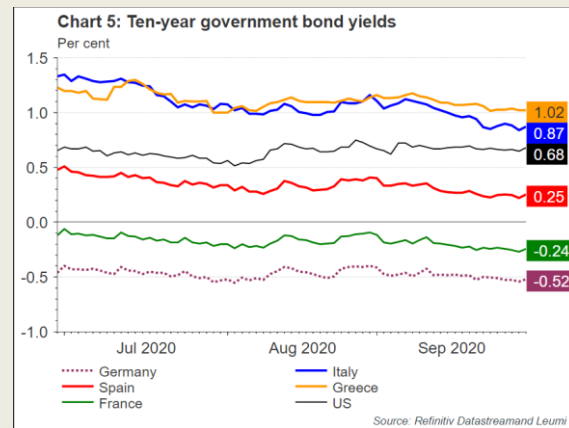
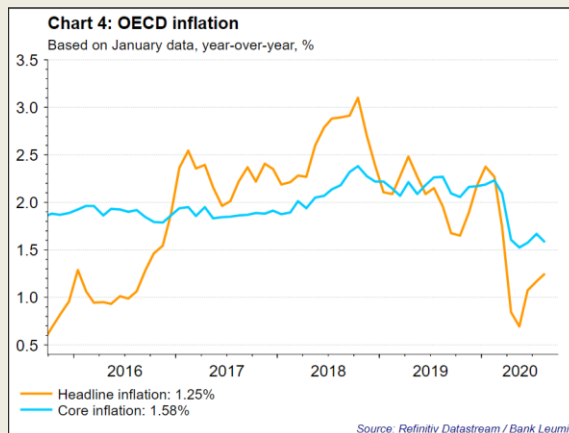
- Inflation in the developed countries increased in July, but in August the annual inflation rate in the euro bloc declined into negative territory, whereas the annual inflation rate in the US continued to increase. The inflation rate in OECD member countries increased in July from 1.1% to 1.2% in annualized terms, while in August there were no substantial changes in the inflation rate (see Chart 4). Meanwhile, the increase in energy and food prices in July was more moderate than in June. The core inflation rate in OECD countries, excluding food and energy, has ranged between 1.6-1.7% over recent months. In Britain, the annual inflation rate dropped sharply in August from 1.0% down to 0.2%, the lowest rate in the last four years. This decline apparently stems from the impact of the cut in the VAT rate in the



accommodation and tourism sectors, and is also due to the government's "Eat Out to Help Out" plan that is intended to help the restaurant and dining sectors.

- According to the minutes of the last meeting of the Federal Open Market Committee (FOMC) in the US, the members of the committee are of the opinion that the interest rate will remain close to zero at least through the end of 2023, and possibly even through the end of 2025. In Canada, the central bank kept the September interest rate unchanged at 0.25%, and in its opinion, this rate is not expected to be increased anytime soon, despite a recovery in housing prices. Furthermore, the bank is expected to continue government bond purchases at a scale of at least CA\$5bn per week. In the bank's opinion, the economy is expected to recover quicker than what was expected back at the beginning of the third quarter; however, uncertainty in the market is expected to continue. In Turkey, the central bank surprisingly hiked its interest rate in September by 200bps, after the rate was lowered from 14.0% back in 2019 all the way down to 8.25%. The interest rate hike stems from the substantial weakness in the Turkish lira, and it is occurring at a time when the inflation rate stands at 11.8% (y/y), more than double the central bank's target rate of 5% in annualized terms. In Mexico, the central bank cut its interest rate 25bp to 4.25%, the lowest interest rate in the last four years. This move shows that the members of the monetary committee are more concerned about the pessimistic outlook on local economic activity than the increase in the inflation rate that occurred over recent months.
- The yields on long-term US government bonds have been in a non-continuous moderate upward trend since the first half of August. This increase comes against the backdrop of concerns over the large financing needs of the US government, coupled with the decline in the overall level of savings in the US (in which the large negative savings of the government is included) relative to the level of real investment. The rise in US yields is reflected in an increase in the steepness of the yield curve, such that the yields at the shorter portion of the curve remain at a very low level, in-line with the Fed interest rate, alongside a rise in longer-term yields, where the US government sources a large amount of its financing needs. In terms of the current equilibrium of the US economy, had it not been for the large volume of bond purchases by the US Fed, the yield on long-term bonds would have been substantially higher than it is today.
- At the same time, the yields on the long-term government bonds of the larger economies of the euro bloc continued to decline throughout September (see Chart 5). FTSE Russell announced it will incorporate the government bonds of China into its World Government Bond Index (WGBI). This move means that passive investment funds will be able to increase their investments in Chinese government bonds. This is expected to raise the market demand for these bonds and to lower their yields, particularly against the backdrop of China's rapid recovery from the spread of the coronavirus and the expected growth in the country this year and in the coming year.





## United States

**Economic activity:** US economic activity continued to recover in the third quarter, alongside a continued spread of the coronavirus throughout the US; in our opinion, economic growth is expected to continue. The housing market strengthened as well, as housing sales continued to increase and the new housing supply in the market fell to its lowest point in recent decades.

- The recovery in US economic activity continued throughout the third quarter of the year, while the coronavirus continued to spread across the US. Retail sales have increased steadily since May, while in August there was a 0.6% increase (m/m). The income of households fell 2.7% in August (m/m), against the backdrop of the decline in government fiscal support and the halt in the US\$600 addition to weekly unemployment benefits. However, consumer expenditures did not decline, and actually increased slightly in August, this perhaps the result of pent-up demand following the weakness in second quarter consumption.
- In addition, the consumer confidence index of the University of Michigan increased in September from 74.1 to 80.4 points, the highest level in the last half-year, providing additional confirmation of the initial estimate that the halt in the additional US\$600 to weekly unemployment benefits has still not hurt the economic recovery. Employment increased in September by 661,000 jobs and the unemployment rate declined in the same month from 8.4% to 7.9%. However, if it were not for the decline in the workforce participation rate, then the unemployment rate would have reached a level of 10%. The workforce participation rate declined 0.3 percentage points to 61.4%. In addition, durable goods orders increased 0.4% in August (m/m) and core orders, excluding shipment, increased as well, by 0.4% (m/m).
- Preliminary indicators in the US (PMI, ISM) show a continuing recovery in economic activity, in both the industrial and the services sectors. The employment component in the ISM index of the services sector increased above 50 points for the first time since February this year. This indicates a return to employment growth in services, which has been the most substantially hurt sector throughout recent months due to the social-distancing restrictions imposed in the economy. Some businesses in the services sectors even closed down for a

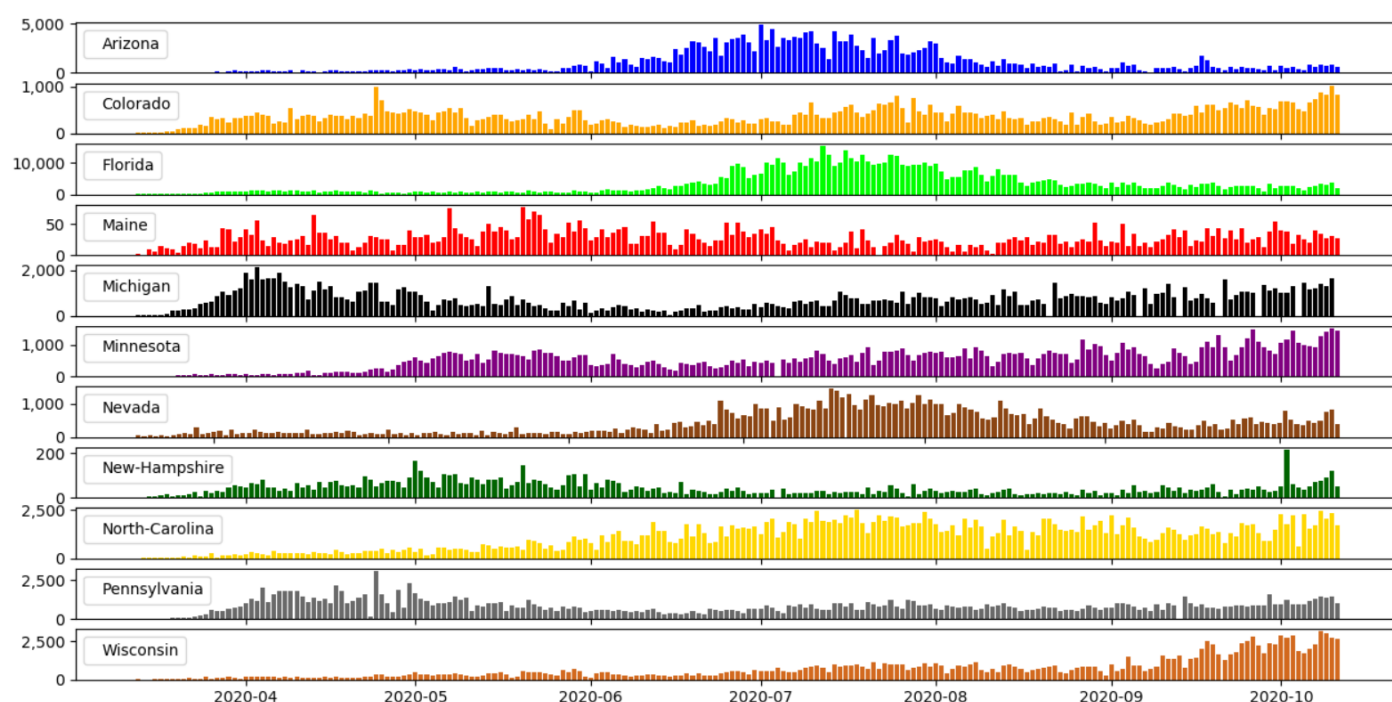
certain period, particularly restaurants, bars, places of entertainment, and businesses in the tourism and leisure sectors. The survey of the Dallas branch of the US Fed covering business activity in Texas, increased steadily since May, and in September, it reached 13.6 points, the highest level since November 2018. Meanwhile, the component involving manufacturing conditions increased sharply and reached its highest level in the last two years, thus supporting a continuation in the growth of business activity.

- New housing units sold increased 4.8% in August (m/m), this in continuation of the upward trend over the last decade, which was interrupted in February-May this year, and it reached its highest level in the last 14 years. The bulk of the increase in sales occurred in the southern areas of the US, where new housing sales increased 13.4% (m/m). This increase has brought the new housing supply in the market to its lowest level since 1963. However, the existing home sales slowed, increasing by a modest rate of only 2.4% in August (m/m) following two months in which sales increased by more than 20% (m/m) each month. The number of new housing units sold in August is 17% of the number of previously owned units that were sold. In our opinion, the slowdown in the market for previously owned homes may indicate that the decline in the supply of new homes will not dramatically impact on the overall market, but instead it is likely to influence a specific segment of homebuyers, which for them a previously owned home is not always a suitable substitute, especially in light of the increasing tendency to move from urban centers to the suburbs. However, the low level of construction starts, compared to the construction levels from before the financial crisis of 2008-2009, has led to a reduction in the inventory of housing compared to the past. This situation supports housing prices.
- The coronavirus is continuing to spread across the US. More than 8m people have been infected by the virus in the US, while the number of deaths attributed to the virus has risen above 200,000. In the event the policies for dealing with the virus in the US will not change, then the number of deaths is expected to climb above 300,000 in the coming months. Apparently, the US is entering a third wave of coronavirus infections that is likely to spread more aggressively than the two preceding waves. This is under the assumption that the policies for dealing with the virus will not change, and that the behavior of the people in the US will remain unchanged compared to the preceding months. The upcoming election in the US, which takes place in the first week of November, is expected to be affected by the spread of morbidity in the US and by the economic situation.
- Among the states that are likely to determine the election results ("swing states"), the spread of the virus in Arizona and in Florida is fading (see Chart 1), which may help the current Republican administration to win the election in these states. This factor is particularly important in Florida, which holds a large number of seats in the Electoral College. In Nevada and in New Hampshire, morbidity declined through the beginning of September, but in recent weeks it has started to climb again. In Maine, the number of new coronavirus patients has equaled tens of cases each day since the outbreak of the virus, and at no stage was a spike in the number of patients registered; however, a drop in morbidity wasn't registered. In Michigan, Minnesota, and Pennsylvania, the morbidity in recent months has been in a moderate upward trend, while in Minnesota the number of daily new infections is at a peak

level. In North Carolina, morbidity has been peaking for a number of weeks, while in Colorado and in Wisconsin morbidity spiked over recent weeks, which is likely to make it difficult for the Republicans to win in those states.

- The former vice-president of the US, Joe Biden, is leading in the polls; yet, actual surprises are possible. However, the gap in Biden's favor exceeds the gap that Hillary Clinton held over Trump in 2016. This is reflected in Biden's favor in a number of "swing states". Furthermore, a candidate does not require a majority of the popular vote to actually win, due to the Electoral College mechanism in the US.
- Apart from the process and outcome of the election, the timing of the emergence of an effective coronavirus vaccine will have a noticeable impact on the markets. A clear and decisive outcome of the election will also be of great importance, as will the timing of a final determination of the winner. In terms of the market effects, it appears that the timing of the release of a vaccine to the market will potentially have a much greater impact than the election results. However, the timing of the vaccine's release (sooner or later) can intensify / moderate the effects of the election results.
- A relatively early approval of an effective vaccine is expected to lead to the following: an increase in economic growth forecasts, particularly of cyclical components; an increase in domestic and foreign stock market indices; a rise in medium-long term US government bond yields; an increase in medium-term expected inflation in the US and in other regions; and a narrowing in corporate bond spreads in the US.
- Key aspects of the economic policies of the Democrats include: a hike in the corporate tax rate (which is apparently partially priced into the market) and wealth taxation; a substantial expansion in government expenditures (infrastructure, healthcare, education, support for states and local authorities, and a minimum wage); some reduction in the severity of foreign trade conflicts; and an emphasis on the environment. The Democrats' policies regarding immigration to the US and the treatment of immigrants are expected to be more accommodative relative to the Trump administration.
- In the event of the re-election of Mr. Trump, with a divided Congress, as is the case today, it appears the current status quo will be maintained in most areas, although the pressure to find a more dovish and cooperative replacement for Mr. Powell at the head of the US Fed will increase.
- A delay of at least a week is expected in the release of the final election results. A situation involving a more substantial delay, and particularly a situation involving a contested election result with doubts of the legitimacy of the results, will negatively affect the level of the stock market and bond yields (decline) in the short-term. This will be a temporary and transient situation, which must be taken into consideration accordingly.
- Looking ahead, in the event there will be no change in how the US deals with the spread of the coronavirus and there will be no local shutdowns, then economic activity is expected to continue to increase in the final quarter of the year, and for all of 2020 the US economy is expected to contract 5.3%. In 2021, the GDP is expected to grow 4.0%.

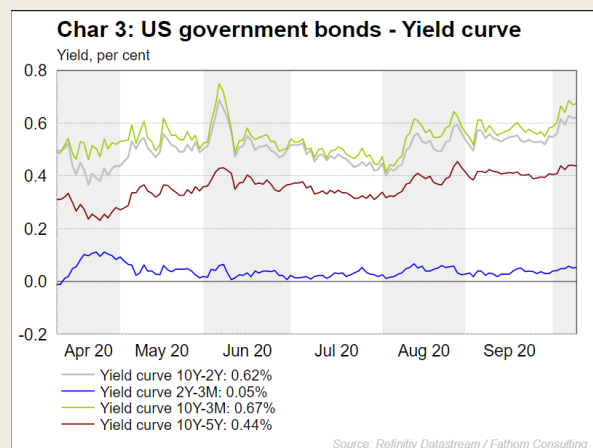
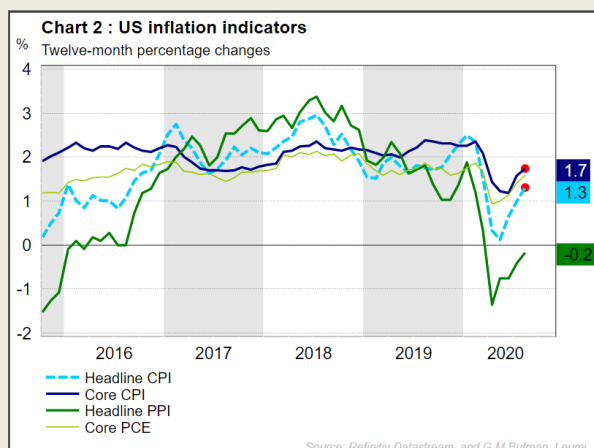
Chart 1: US swing states - Covid-19 Daily New Cases



**Inflation and monetary policy: the members of the FOMC raised the economic forecast and they estimate the interest rate will remain at a near-zero level at least until 2023. Long-term government bond yields increased in recent weeks and led to a rise in the medium and longer portions of the yield curve.**

- From the minutes of the September 2020 meeting of the FOMC it can be seen that the committee members raised their economic forecast for the US economy due to the data indicating that economic activity is recovering quicker than expected and that consumer prices increased in recent months quicker than expected. In this situation, there is no need to consider raising the pace of asset purchases by the Fed. The Fed conditioned the raising of the positive outlook for the recovery of the economy on the condition that there would be additional fiscal support, and the participants in the meeting indeed assumed there will be additional support from the administration.
- However, the Fed has qualified its forecast such that if fiscal support is less than expected or arrives too late, then the rate of recovery may be slower. The members of the committee are of the opinion that the interest rate will remain near-zero at least through the end of 2023, and possibly even beyond this period. Yields on 5-year government bonds are approximately 0.2%, and it appears the market is pricing this value into bond prices and is not expecting any substantial increase in the interest rate in the coming years. This estimate is consistent with the strategy of the Chairman of the Fed. This strategy suggests that the interest rate will remain near-zero until the conditions of the labor market will reach levels consistent with an assessment of full employment, and the annual inflation rate will converge toward a moderate upward trend and will rise slightly above the 2% inflation target for a certain period.

- The consumer price index (CPI) increased in August by 0.4% (m/m; see Chart 2) and inflation increased to an annual rate of 1.3%, primarily due to a rise in automobile prices, which likely indicates supply chain problems, that is to say, the effect of narrowing supply. Core inflation increased 1.6% in August (y/y) to 1.7% (y/y), due to a rise in automobile insurance prices and airplane ticket prices. The 0.3% increase in the August producer price index in the US (m/m) illustrates the speed of the recovery in prices that have started to rise again, with the ending of shutdowns and the lifting of restrictions on the economy. Looking ahead, the inflation rate is expected to continue to climb at a slower pace, as manufacturers restock inventory levels, which fell substantially over recent months.
- The yields-to-maturity of long-term US government bonds have been in an unsteady, moderate upward trend since the first half of August. This is due to concerns regarding the large financing needs of the US government, this coupled with a decline in the overall savings rate in the US, of households, businesses, and the government, relative to the real level of investment as a percentage of GDP. The rise in yields has led to an increase in the slope of the yield curve, particularly at the long and medium portions (2Y-10Y, 3M-10Y; see Chart 3). The rise in the steepness of the curve reflects the low yield of short-term government bonds, in accordance with the Fed interest rate. The bond yields are also affected by the large purchases of the Fed, such that without these large purchases, the yields would be substantially higher, particularly with respect to the longer-term bonds.



## The Euro Bloc

**Economic activity: the recovery in economic activity within the euro bloc is continuing, while retail sales have increased above pre-crisis levels. Preliminary indicators show a slight slowdown, particularly in the services sector, due to the rise in morbidity.**

- The third estimate of the euro bloc's second quarter GDP was revised slightly, from a 12.1% contraction to a contraction of 11.8%, in quarterly terms. However, the revised estimate has not changed the big picture and thus GDP remains 15% below the level it was at in the parallel period last year. Industrial production in the euro bloc is in the midst of a recovery and has risen steadily since May. In July, industrial production increased 4.1% (m/m), and remains

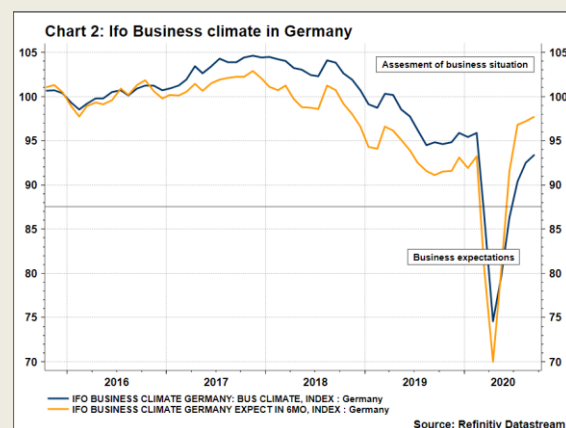
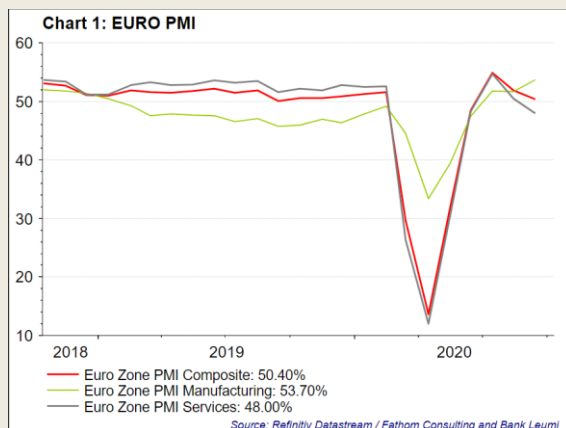


7.3% below its level from February this year, prior to the economic crisis. Retail sales in the euro bloc increased 4.4% in August (m/m), reaching a level higher than that in February, prior to the outbreak of the crisis. Consumer confidence of the euro bloc increased in September, despite the continued spread of the virus across the continent and the tightening of social distancing restrictions that are intended to halt the spread of the virus. However, in the event the virus will continue to spread and the restrictions will be tightened further, then a drop in consumer confidence is likely during the final quarter of the year. The unemployment rate in the euro bloc increased in August from 8.0% to 8.1%, thus indicating the fragility of the market despite government programs supporting the labor market. In the coming months, the unemployment rate is likely to continue to climb, with the conclusion of the government's "Short-time work" plan, which has supported the labor market.

- Preliminary indicators show continuing growth of the economy, albeit at a lower rate. The composite PMI of the euro bloc declined in September from 51.9 to 50.4 points (see Chart 1), yet it still reflects slight growth (a value above 50 points). This is due to the spread of the coronavirus in the large economies of the euro bloc and concerns regarding a tightening of restrictions and the return of economic shutdowns in some areas. Furthermore, the economic sentiment indicator of the euro bloc (ESI) increased slightly in September and now also indicates continued slight growth in economic activity.
- In a country breakdown, industrial production in Germany contracted 0.2% in August (m/m) and is currently 9.6% lower in annualized terms and is 12% below its level registered back in February, prior to the outbreak of the virus. The recovery in German industry is slow compared to that of the other large economies in the euro bloc. For the sake of comparison, industrial production in Italy increased 7.7% in August (m/m) and reached a higher level than that registered in February; however, the rise in morbidity threatens the continued growth in Italian industry, where growth has been relatively rapid compared to the rest of the countries of Europe since May. In Spain and France, industrial production is 3% and 6% lower (respectively) than their levels back in February.
- Preliminary indicators indicate the inherent risk of the spread of morbidity on continued growth of economic activity in the economy in general, and in the services sector in particular, in the fourth quarter of 2020. In Germany, the composite PMI declined slightly due to a drop in the index of the services sector and despite an increase in the industrial production index; however, the index level still indicates continuing growth in economic activity, in both industry as well as in services. The minor increase in the IFO index, measuring the business climate in Germany, stems primarily from a rise in industrial production that is intended in part for export, and comes against the backdrop of an increase in expectations for external demand that offset the drop in demand for local services, and it indicates a slowdown in the recovery in economic activity (see Chart 2). In Spain and France, the composite index indicates a slight contraction in the services sector, and in Italy the PMI of the services sector indicates a substantial contraction. This comes against the backdrop of an increase in morbidity from the coronavirus and the daily number of infections, which is at a peak level in the larger economies of the euro bloc. We note that the rise in morbidity in Spain has led to an increased severity in economic restrictions, and even to local shutdowns that are

expected to weigh on the continuation in the economic recovery. The rise in morbidity will also likely put a halt to the recovery that started with the return of activity following the closure imposed back at the time of the first wave of the spread of the coronavirus.

- Looking ahead, the spread of morbidity in the euro bloc is likely to weigh on the economic recovery. In the opinion of the IMF, from its October 13 forecast, the GDP of the euro bloc is expected to contract 8.3% in 2020, contraction that has already occurred in the first half of 2020, while GDP is expected to grow 5.2% in 2021. However, the GDP is not expected to return to its level from 2019 before year-end 2022.

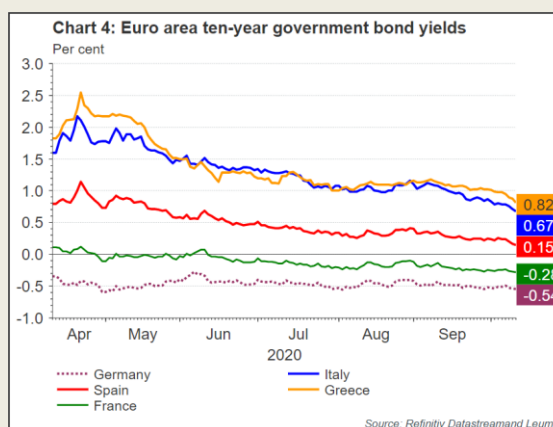
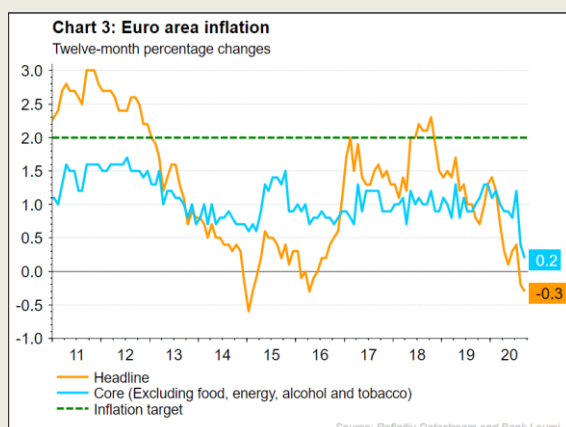


**Inflation and monetary policy: the ECB estimates it will use the total amount allocated to the Pandemic Emergency Purchase Program (PEPP). The annual rate of inflation of the euro bloc declined to a negative level of -0.3%, and core inflation fell to an annual rate of 0.2%. In our opinion, the inflation rate is expected to increase in the coming months.**

- A look at the minutes of the monetary committee of the ECB from September shows that the committee members are in no hurry to increase the sum of the emergency purchases of the central bank through the PEPP. In their opinion, it will probably be necessary to use the entire amount allocated to the PEPP plan; however, the monetary committee has not discussed expanding the amount of the program. In addition, the ECB expects growth in the third quarter of this year will be higher than the central bank had originally forecast; however, the central bank noted there are risks that are likely to slow the recovery, including the spread of the coronavirus and the high savings rate of households. In addition, the monetary committee left the 2022 inflation forecast unchanged at an annual rate of 1.3%; however, the forecast for core inflation in 2022 increased from 0.9% to 1.1% in annualized terms.
- From the speech of the ECB president at the end of September, it is understood that she supports raising the inflation target and transitioning from a specific inflation target to a multi-year average inflation target as part of the ECB's strategic analysis. Such a mechanism is similar to the change in approach adopted recently by the US Fed. This is in contrast to the current inflation target of "slightly below 2%" that was established back in 2003 in accordance with the spirit of that time period, when the main concern was over a high inflation rate. This change is expected to support keeping the interest rate low and narrow margins of government bonds of the larger, euro bloc member economies.



- The consumer price index of the euro bloc (HICP) continued to decline in September, by 0.1%, after reaching a negative level in August, and the annual inflation rate fell to -0.3% (see Chart 3). The core inflation rate declined as well, to 0.2% (y/y). In our opinion, the inflation rate is expected to increase in the coming months due to the expected rise in energy prices, and an expected increase in Germany's VAT rate, which was previously lowered in order to incentivize economic activity. Also, we do not foresee any further substantial declines in tourism prices, which are currently at a low following the sharp declines in the first half of the year. In the opinion of the IMF, the annual rate of inflation in 2020 is expected to equal 0.4%, and in 2021 it is expected to reach 0.9%. What this means is that the inflation environment is below one percent, which supports a continuation of expansionary monetary policy also in 2021 and even beyond this period.
- The yields-to-maturity of long-term government bonds in the larger economies of the euro bloc have been in a moderate downward trend over recent months. This downtrend has strengthened in the first half of October (see Chart 4). In Germany, the steepness of the government bond yield curve increased from mid-September across the entire curve. The yield spread, at durations of ten years to maturity and longer, between Italy and Germany, declined recently, possibly reflecting the fact that until recently Italy has been dealing with the "second wave" relatively better than Germany, a development that is expressed in a relatively rapid recovery in Italian industry. These changes apparently stem from the emergency bond purchase plan of the ECB and show that investors in the market estimate that the ECB will back the bonds of the Italian government if necessary. The yield spreads between Italian and German bonds narrowed also among the relatively shorter bond durations.



### **Disclaimer**

The data, information, opinions and forecasts published in this publication (the “Information”) are furnished as a service to the readers and do not necessarily reflect the official position of the Bank. The above should not be seen as a recommendation and should not replace the independent discretion of the reader, nor should it be considered an offer or invitation to receive offers or advice – whether in general or in consideration of the particular data and requirements of the reader – to purchase and /or to effect investments and/or operations or transactions of any kind.

The Information may contain errors and is subject to changes in the market and to other changes. Likewise, significant discrepancies may arise between the forecasts contained in this booklet and actual results. The Bank does not undertake to provide the readers with notice, in advance or in retrospect, of any of the aforementioned changes by any means whatsoever.

The Bank and/or its subsidiaries and/or its affiliates and/or the parties controlling and/or parties having an interest in any of them may, from time to time, have an interest in the information represented in the publication, including in the financial assets represented therein.

---

**BANK LEUMI LE-ISRAEL, THE CAPITAL MARKETS DIVISION**  
**The Economics Sector, P.O. Box 2, Tel Aviv 61000**  
**Ph: 972-76-885-8737, Fax: 972-77-895-8737, e-mail: [Gilbu@bll.co.il](mailto:Gilbu@bll.co.il)**  
**<http://english.leumi.co.il/Home/>**