

Global Macroeconomic Monthly Review

February 2021

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)

- *US economic activity continues to recover while the euro bloc's recovery slowed and GDP in the final quarter of 2020 contracted slightly in the fourth quarter of 2020.*
- *The current shutdowns are having less of an impact on GDP than that experienced at the time of the first shutdowns at the start of the pandemic, both due to their targeted, non-blanketed, implementation in the regions of virus spread and due to the business environment's ability to adapt to the new conditions.*
- *Inflation in the developed countries remained unchanged in December 2020, and in the euro bloc it increased in early 2021.*

United States (p. 9)

- *US GDP increased 4.0% in the fourth quarter of 2020 (y/y) and growth is expected to continue, supported by additional fiscal stimulus.*
- *Tightened economic restrictions have weighed on retail sales; however, with the removal of restrictions, demand is expected to return and sales will recover.*
- *The IMF expects the US will suffer less damage than the average in developed countries.*
- *The medium- and long-term forecasts of the Fed are more optimistic against the backdrop of the vaccinations occurring across the country, which are expected to lower the risks.*
- *The Fed is expected to continue its asset purchases throughout the year and consequently the Fed's balance sheet is expected to reach US\$9tn.*
- *The consumer price index (CPI) increased in December 2020, and in our opinion, the rate of price increases will pass the 2.0% target, during the coming year.*

Euro Bloc (p. 13)

- *Euro bloc GDP contracted in the final quarter of 2020 as economic restrictions tightened in many areas.*
- *GDP in Germany and Spain increased slightly in the fourth quarter of 2020, but the GDP of Italy and France contracted.*
- *Continued spread of morbidity, coupled with a slow vaccination rollout, will hamper the economic recovery of the euro bloc.*
- *The ECB kept its monetary policy unchanged, and the central bank estimates it will take time for the population to be vaccinated, which also has implications for the resolution of the crisis.*
- *The consumer price index (CPI) increased sharply in early 2021.*
- *Long-term government bond yields increased slightly in January, with a temporary emphasis on Italian government bonds due to political instability*

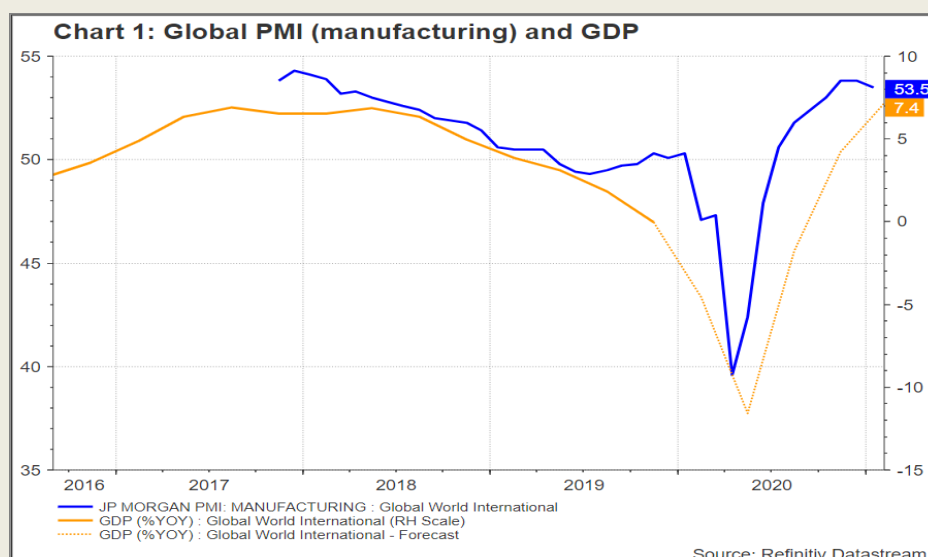
Leumi Global Economic Forecast, As of February 2021

| | 2017 | 2018 | 2019E | 2020F | 2021F |
|------------------------------------|-------------|-------------|--------------|--------------|--------------|
| GDP – Real Growth Rate | | | | | |
| <i>World</i> | 3.8% | 3.5% | 2.6% | -3.6% | 4.8% |
| <i>USA</i> | 2.3% | 3.0% | 2.2% | -3.6% | 3.7% |
| <i>UK</i> | 1.7% | 1.3% | 1.3% | -11.3% | 4.5% |
| <i>Japan</i> | 2.2% | 0.3% | 0.7% | -5.3% | 1.7% |
| <i>Eurozone</i> | 2.7% | 1.9% | 1.3% | -7.4% | 4.8% |
| <i>South East Asia (ex. Japan)</i> | 5.3% | 5.1% | 4.4% | -3.9% | 4.4% |
| <i>China</i> | 6.8% | 6.6% | 6.1% | 2.3% | 8.7% |
| <i>India</i> | 7.0% | 6.1% | 4.2% | -7.9% | 6.9% |
| <i>Latin America</i> | 0.9% | 0.8% | -0.5% | -7.4% | 3.9% |
| <i>Israel</i> | 3.6% | 3.5% | 3.4% | -3.9% | 4.9% |
| Trade Volume, Growth (%) | | | | | |
| <i>Global</i> | 5.8% | 3.7% | 0.9% | -9.8% | 7.0% |
| Interest rates, Year End | | | | | |
| <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% | 0.1% | 0.00-0.25% |

The Global Economy – Overview

Economic activity: US economic activity continues to recover while the euro bloc's recovery slowed and GDP in the final quarter of 2020 contracted slightly in the fourth quarter of 2020. The current shutdowns are having less of an impact on GDP than that experienced at the time of the first shutdowns at the start of the pandemic, both due to their targeted, non-blanketed, implementation in the regions of virus spread and due to the business environment's ability to adapt to the new conditions.

- The different methods by which countries have dealt with the spread of morbidity have led to large differences in the manner of recovery in economic activity in each country. Whereas the GDP of the US continued to recover in the final quarter of 2020, the GDP of the euro bloc contracted in the fourth quarter of 2020 against the backdrop of tighter restrictions and the implementation of shutdowns in some regions. Within the euro bloc as well there are differences in the intensity of the harm to economic activity in accordance to the spread of the disease and the policies implemented in dealing with the spread of the virus.
- Preliminary indicators show the global economy is expected to grow in the beginning of 2021 by a more moderate rate than that at the end of 2020 (see Chart 1), but the differences between the countries are expected to remain. In the US, the economic activity in industry and services is expected to continue to recover, whereas in the euro bloc the activity in the services sector is expected to contract while the industrial sector's recovery is expected to slow. This is due to the continuation of restrictions on economic activity and shutdowns in some euro bloc member countries that are intended to halt the spread of the disease across Europe.
- In Britain, GDP contracted by 9.9% in 2020. GDP increased slightly in the last quarter of 2020, by 1.0%, and this is despite the lockdown measures that were implemented. The implementation of the second economic shutdown across the country was less severe than the first shutdown back in April 2020. The broad vaccination rollout is expected to help the economy to recover in the remainder of 2021, after a fall in the rate of spread of the disease. Retail sales increased 0.3% in December 2020 (m/m), following a sharp drop of 4.1% (m/m) in November, resulting from the shutdown imposed on the country against the backdrop of the spread of the virus.



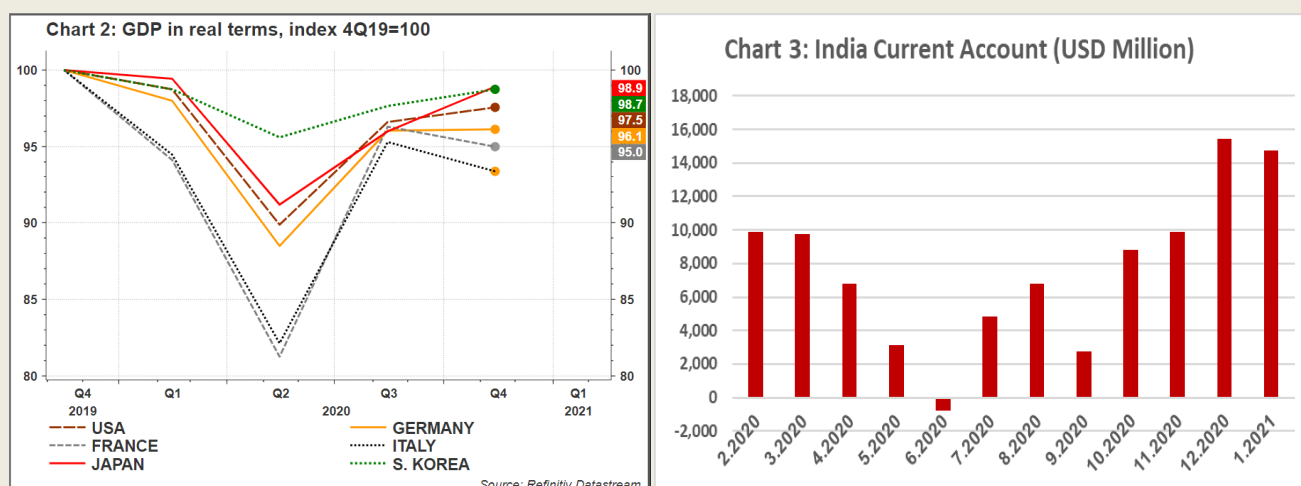
- The rise in sales was weak despite the renewal of broad retail activity in early December, since some retailers were required to close shop once again on December 20 in the regions in which restrictions were tightened as the Christmas holiday approached. Food sales declined 3.4% in December (m/m), yet on the other hand, clothing sales increased 21.5% (m/m) following a decline of 19.6% (m/m) in November. Retail sales did not contribute to December GDP, and in our assessment, the tightening in restrictions is expected to lower retail sales, and this is likely to affect the contraction in GDP in January-February this year. Britain's PMI declined in January against the backdrop of the third economic shutdown imposed on the country; however, the index indicates the damage to economic activity will be less severe than that experienced in the first shutdown. The bulk of the decline stemmed from the index of the services sector, which indicates a contraction in the economic activity of this sector; however, the index indicates that the growth rate of the industrial sector is expected to be harmed as well by the tightening in restrictions, albeit by a lesser degree.
- In Japan, the tightening of the shutdowns led to a decline in retail sales in December 2020, after these had fallen in November, and consumer confidence continued to fall in early 2021, suggesting that retail sales remained weak due to the tightening of restrictions. The January decline in the Economy Watchers Survey, which is published by the government of Japan and measures the business environment among businesses in Japan's services sector, after this index had fallen also in the two preceding months, indicates that the third wave of the coronavirus is likely to continue to weigh on consumer confidence. Consequently, consumer expenditures are likely to contract in the first quarter of 2021. However, the expectations component for the next two-three months increased to the highest level since October 2020 and now indicates the expectations in the market for recovery in activity with the easing in the restrictions and the lifting of the shutdowns that were imposed on the country.
- Japan's GDP increased by 3.0% (q/q) in the fourth quarter of 2020 and it remains only 0.5% below the level before the coronavirus outbreak. Non-residential business sector investments and net foreign trade contributed a significant portion to the GDP's increase. In addition, private consumption rose with an emphasis on the purchase of durable goods and services. In our view, Japan's GDP will increase 2-3% during the coming year.
- Singapore's GDP increased by 3.8% (q/q) in the last quarter of 2020, after it increased 9.0% (q/q) in the third quarter. A significant portion of this growth was due to the industrial sector, while the recovery of the construction sector was significantly strong. In our view, the strong recovery in Singapore will continue throughout 2021 against the background of the halt spread of the coronavirus which is expected to enable a return of economic activity together with the government's fiscal support which is expected to continue.
- The PMI of Japan declined slightly in January against the backdrop of the tightening in restrictions within the country, but indicates that the tightening in restrictions will have less of an impact compared to the case in the first economic shutdown that occurred in the first half of 2020. The PMI of the industrial sector declined, for the first time since May 2020, yet the bulk of the decline was as expected in the PMI of the services sector, which indicates that this sector is expected to be the main sufferer also in the tightening of the current restrictions.
- The rate of recovery in South Korean economic activity slowed towards the end of 2020, as the country's GDP growth slowed in the final quarter of 2020 to 1.1% (q/q), after GDP had

grown at a rate of 2.1% (q/q) in the third quarter of 2020. For all of 2020, South Korean GDP growth was hurt by the crisis less than most of the other developed countries (see Chart 2). The spread of the third wave of the virus in the country is in a downward trend after the number of new patients reached a peak of 1,237 persons per day, and in the event this trend will continue, then an easing in the restrictions can be expected. Such a development will cause an increase in consumer confidence and a rise in private consumption, which is currently 5% below the pre-crisis level.

- All this is expected to contribute to a continued increase in GDP. In our assessment, the recovery in growth in 2021 is expected to reflect a substantial weighting of private consumption and broad government support. Exports as well are expected to remain strong in the near-term and to continue to reflect the changes in global consumption patterns. The global demand for semiconductors manufactured in South Korea is expected to be strong, supported by global investment in data centers and 5G network infrastructures.
- Economic activity in the developing countries continued also in the final quarter of 2020 and the preliminary indicators show continued recovery in their economic activity in early 2021, with an emphasis on the industrial sector. The GDP of China increased 6.5% in the fourth quarter of 2020 (y/y), representing the highest growth rate in the last two years, after the economy had grown 4.9% (y/y) in the third quarter. The tightening of restrictions in China and the implementation of regional shutdowns against the backdrop of a renewed outbreak of the virus are expected to hamper the economic recovery of China. However, the damage to industry is expected to be relatively low because in this period the Chinese new year holiday occurred, consequently there is a decline in industrial activity in this period of the year.
- The PMI of China continued to decline in January, following the decline in December 2020, yet the index remains above 50 points, and indicates a slowdown in the rate of expansion of industry and services. Furthermore, the consumer confidence index declined in January by a very moderate rate relative to the decline in the index at the time of the first shutdown, which likely indicates that industry expects the damage from the current economic shutdown to the business activity of the sector to be weak.
- The deficit in India's goods trade account expanded in December 2020 from US\$9.9bn to US\$15.4bn, representing the largest deficit over the last 18 months. In January 2021, this deficit contracted slightly, but still remains very high (see Chart 3). In our view, the expansion in the deficit is expected to continue, against the backdrop of the recovery in local demand, coupled with the rise in global oil prices that raises the expenditure on India's imports. The expansion in the deficit in the goods trade account is expected to erase the surplus that was created in the current account, and to even create a deficit equivalent to one percent of GDP in 2021. The PMI of India indicates continued recovery in industry in January, and the new export orders component of the index increased as well. However, the employment component of the index remains low, indicating that the recovery in the labor market is progressing slowly, which is also likely to slow in the remainder of the year the pace of recovery of industry. The PMI of the services sector increased slightly in January, indicating continued growth of economic activity also in the services sector.
- In Poland, GDP contracted 2.8% in 2020, with this being the first annual contraction in GDP for the country since the fall of the Soviet Union. The vaccination rollout in Poland started

slow and late, but recently the process has accelerated. In our view, the restrictions implemented in the country with the goal of preventing the spread of the virus will hamper the recovery in economic activity in the first quarter of 2021, but a recovery is expected later during the year and to a stronger degree than in other countries in central Europe.

- Industrial manufacturing in Poland increased 11.2% in December last year (y/y), after having increased 5.4% (y/y) in November against the backdrop of the continuing decline in morbidity and the easing in the restrictions that were implemented in the country that are expected to actually lead to a rise in retail sales. Industrial manufacturing remains higher than the pre-crisis level. The growth in industrial manufacturing was broad and supported by growth in the manufacture of automobiles, computers, electronics, and textiles. In addition, mining output increased in annualized terms for the first time since November 2019. In our view, the economic activity of Poland is expected to continue to recover this year and to show better performance than other developing countries in Europe.
- In South America, the GDP of Mexico increased 3.1% in the final quarter of 2020 (q/q) after it had increased by a rate of 12.1% (q/q) in the third quarter. However, the rise in morbidity is likely to weigh on the continuation of the recovery during the first quarter of 2021, and may perhaps even cause a slight contraction in GDP. In Ecuador, elections for president are being conducted, which is likely to have a strong impact on the future economic stability of the country.
- The left-wing Ecuadorian presidential candidate, Andres Arauz, who is leading in the polls, declared he will not comply with the requirements of the IMF for a fiscal reduction as part of a re-scheduling arrangement on US\$6.5bn of debt. Furthermore, he will actually expand direct government support for the population by one billion dollars, by means of a US\$1,000 transfer payment per person to one million residents. In addition, he supports the use of central bank transfers to finance public expenditures through loans to the government from the central bank, a measure that raises the debt risk of the country, which is already shaky. Nonetheless, he has committed that if he will be elected, the country will continue to pay bondholders.
- Looking ahead, the IMF estimated in January 2021 that global GDP contracted 3.5% in 2020, but growth is expected to reach 5.5% this year, such that already this year GDP will return to its pre-crisis level. Meanwhile, the main damage during the crisis occurred in the developed countries, with the GDP of these countries having contracted 4.9% in 2020, with 4.3% growth expected in 2021, yet they will return to the pre-crisis GDP level only in 2022. This is in contrast to the developing countries, as their GDP contracted 2.4% in 2020, with expected growth of 6.3% in 2021. Furthermore, the IMF expects that international trade contracted 9.6% in 2020, but is expected to grow 8.1% in 2021, and in 2022 it is expected to continue to increase, by a rate of 6.3%.

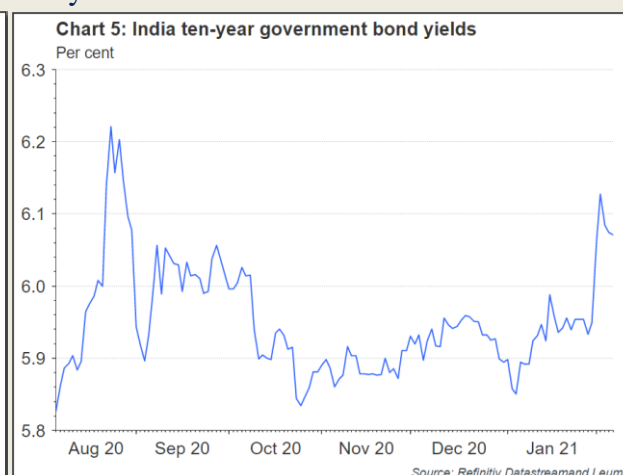
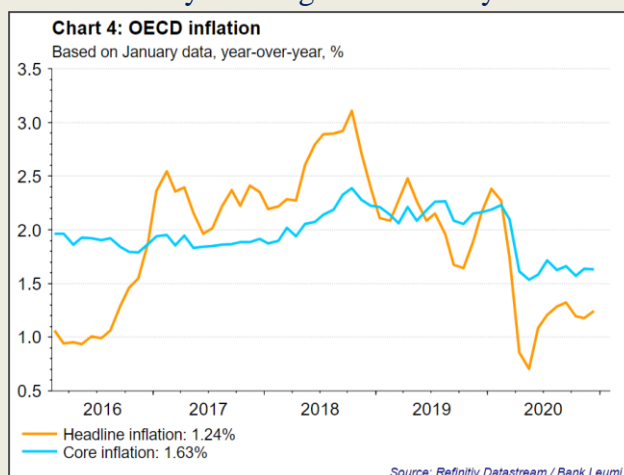


Inflation and monetary policy: inflation in the developed countries remained unchanged in December 2020, and in the euro bloc it increased in early 2021.

- Inflation in the euro bloc increased in early 2021, returning to positive territory after five months in which the annual inflation rate was negative. Annual inflation in the OECD remained unchanged in December 2020, for the third consecutive month, at an annual rate of 1.2% (see Chart 4). The changes in food and energy prices were smaller than in November 2020, while the energy component in the index declined 6.5% in December and the food component increased 3.2%. Core inflation (excluding food and energy) remained in December 2020 unchanged as well, at an annual rate of 1.6%.
- The Fed expects the economic recovery in the US slowed towards the end of 2020, but the forecast for the medium- and long-terms is optimistic, due to the start of a broad vaccination rollout for the population, which is expected to reduce the risks for a slowdown in economic activity. The Fed is expected to continue asset purchases throughout the current year, such that the Fed balance sheet is likely to reach US\$9tn, more than double its balance prior to the current crisis. The ECB kept monetary policy unchanged and it forecasts that the interest rate will remain at its current low level until the inflation rate will converge toward the target of slightly less than 2%. The ECB expects that the vaccination of the population increases the chances for resolving the current crisis, but it forecasts that it will take time to vaccinate a substantial portion of the EU population, and concerns remain regarding other negative developments related to the pandemic.
- The monetary committee of the central bank of England kept the interest rate unchanged at its rate of 0.1%, as well as the inventory of asset purchases totaling GBP895bn. The central bank also noted that for the moment a negative interest rate is not being considered. The committee's statement emphasizes that the financial companies in England are still not prepared to deal with a negative interest rate, but they must prepare for the possibility of a negative rate at any moment in time from another six months and onwards. However, the central bank of England believes that despite the shutdowns in the country in response to the virus spread, for the moment there are not many signs that there will be a need for a negative interest rate and/or an expansion in monetary policy through new instruments. The economic forecasts of the central bank of England are more optimistic than the previous estimates, as the bank currently forecasts that GDP will return to its pre-crisis level in the fourth quarter of

2021. Furthermore, it believes the unemployment rate will reach a peak of 7.8%, compared to 5.0% in November 2020 and that the inflation rate will be slightly above 2.0% starting from the second half of 2022 and throughout 2023. Despite the optimism expressed in the forecast, the bank emphasized that monetary policy will not be tightened until the inflation rate will achieve the 2% target for an extended period. In our view, the bank is also not expected to lower the interest rate to a negative level or to expand the total of its asset purchases.

- The yields-to-maturity of long-term US bonds and of the major economies of the euro bloc increased slightly in early 2021. In particular, the yields of the long-term bonds of Italy increased against the backdrop of the political tensions in that country resulting from the resignation of the prime minister and the attempts to form a government by another candidate while preventing elections during this period of pandemic. In South America, the yields of Brazilian bonds increased in the beginning of the month against the backdrop of the high morbidity in the country.
- Long-term bond yields in India rose in January to above 6% (see Chart 5) following the government's announcement of a state budget that includes broad fiscal support and an increase in public expenditure, which could increase the country's bond issues to finance the deficit that will be created. We do not agree with the market assessment of the possibility for tighter monetary policy, as it is expected to take quite some time for the central bank of India to raise the interest rate, especially against the backdrop of the decline in India's inflation rate at the end of 2020. Thus, overall, we estimate that India's long-term government bond yields are not expected to continue to rise substantially beyond the increase already registered, and later there may be a slight decline in yields-to-maturity back below 6%.



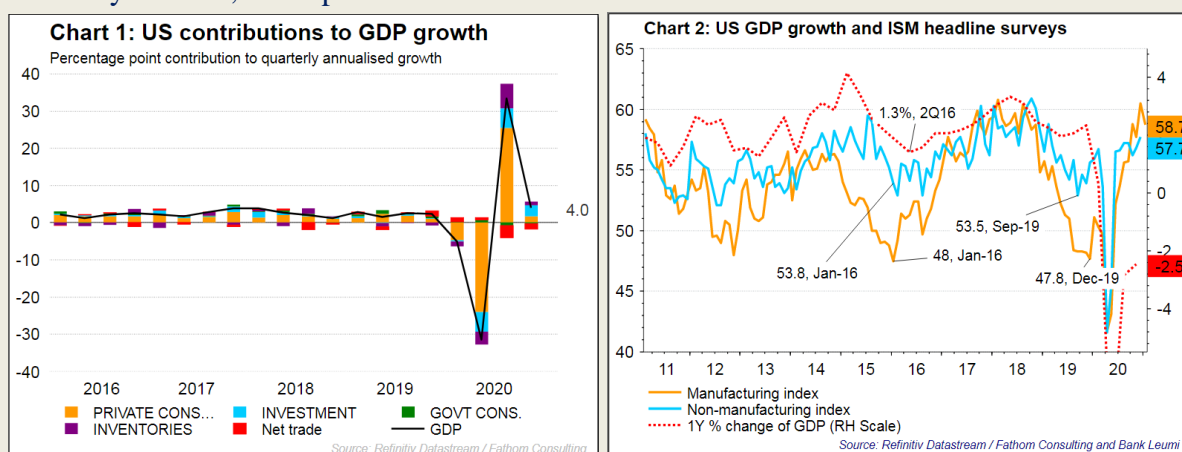
United States

Economic activity: US GDP increased 4.0% in the fourth quarter of 2020 (y/y) and growth is expected to continue, supported by additional fiscal stimulus. Tightened economic restrictions have weighed on retail sales; however, with the removal of restrictions, demand is expected to return and sales will recover. The IMF expects the US will suffer less damage than the average in developed countries.

- The recovery in US economic activity continued at the end of the final quarter of 2020 and activity is expected to expand further during the first quarter of 2021, supported by a fiscal stimulus package totaling more than US\$900bn that was approved at the end of 2020. GDP in the final quarter of 2020 increased by an annual rate of 4.0% (y/y, see Chart 1), despite weakness in private consumption stemming from the tightening of restrictions in some regions of the country in response to the rise in morbidity. However, the slowdown in the rate of private consumption growth is occurring at the same time that the savings rate of households remains high. This indicates that pent up demand will likely be released after an easing in the restrictions on social distancing.
- In contrast, growth in fixed capital investments of the private sector strengthened with an increase of 18.4% (y/y), stemming primarily from an increase of 33.5% (y/y) in investment in residential construction and an increase of 24.9% (y/y) in investment in business equipment. Public consumption declined 1.2% (y/y) and inventory stockpiling contributed one percentage point to GDP growth. On the other hand, net external trade lowered GDP by 1.5 percentage points, as the increase in exports was less than the rise in imports.
- Retail sales decreased in December 2020, representing the third consecutive month of declines, indicating that the spread of the coronavirus continues to weigh on retail economic activity. The consumer confidence index of the University of Michigan fell in January, indicating that retail sales will remain weak despite the prevailing optimism in the markets due to the expansion in fiscal stimulus – referring to the expansion that has already been approved, and the additional future expansion initiated by the new president. In our opinion, retail sales are expected to remain weak until the vaccination of a substantial portion of the population, which will enable the return of full economic activity and the removal of the restrictions that were tightened recently in a number of regions of the country. In contrast, industrial manufacturing continued to grow consistently also in December 2020.
- The January PMI indicates continuing economic growth in the beginning of 2021 in the services and in the industrial sectors. The PMI of the industrial sector reached an historic peak of 59.1, indicating continued positive momentum in the sector, and the ISM index also remained at a very high level despite a decline in January (see Chart 2). Durable goods orders weakened in December 2020 by 0.2% (m/m), primarily due to aircraft manufacturing problems at Boeing Corporation and a fall in defense orders. Core goods orders continued to climb in December 2020, indicating a continued recovery in investments, which are expected to continue to increase in the coming months.
- The incoming US president, Joe Biden, proposed an addition of US\$1.9tn, or 9% of GDP, to the fiscal stimulus package. This is after Congress increased in December the stimulus package by about US\$900bn. Part of this stimulus package is intended to increase the grants to eligible households from US\$600 to US\$2,000, and to raise the additional unemployment payments from US\$300 to US\$400 per week, and also an extension in the duration of this additional benefit at least until September, instead of until mid-March. This part of the new president's proposal is expected to pass Congress even with the support of a number of Republican members of Congress. However, the other additions included in the proposal that involve a US\$350bn increase in the support to state and local authorities and also the addition

of 100,000 public health positions, as well as increased public spending on health insurance, are expected to encounter Republican opposition. In addition, President Biden is expected to advance an initiative to more than double the minimum wage, from US\$7.25 to US\$15.00 per hour.

- The combination of the rise in housing demand following the economic shutdowns that occurred in the US together with the decline in the housing supply, led to an 8.4% increase in housing prices in October 2020 (y/y). However, from the point of view of homebuyers, the rise in prices was offset by low mortgage rates in the economy. The expected rise in mortgage interest rates, after yields on long-term US government bonds rose to above 1%, together with the decline in consumer confidence, are expected to slightly "cool" the hot housing market during the coming months. At the same time, construction starts of single-family homes increased 12% in December (m/m), representing the largest monthly increase since June 2020, and this propelled the rise in total construction starts in the economy, which increased 5.8% in December (m/m).
- Morbidity is continuing to spread across the US, yet in the second half of January the number of new daily patients declined, against the backdrop of a tightening in economic restrictions in some regions of the country. The decline in morbidity in California, which has suffered the highest number of people infected with the virus in the US, led to an easing in the shutdown measures. Also in New York, which is also one of the major centers of morbidity in the US, an easing in restrictions has begun with the start of a decline in morbidity. The US is currently vaccinating approximately one million people per day, placing the country in a relatively good position. This is because of the country's domestic vaccine production capability, while export restrictions will prevent vaccine supply problems, in contrast to supply problems in other countries.
- Looking ahead, in January 2021 the IMF estimated that US GDP contracted 3.4% in 2020, while growth is expected to reach 5.1% in 2021, such that already during this year GDP will return to its 2019 level. This estimate reflects the relatively low damage caused by the crisis in the US compared to the average in the developed countries of the world. The IMF expects that developed countries contracted by an average of 4.9% in 2020, with an average increase of 4.3% expected in 2021. In our opinion, the estimate of the IMF is slightly mitigating the current crisis in US economic activity. Thus, following the 3.5% contraction of the US economy in 2020, we expect a 3.7% increase in 2021.

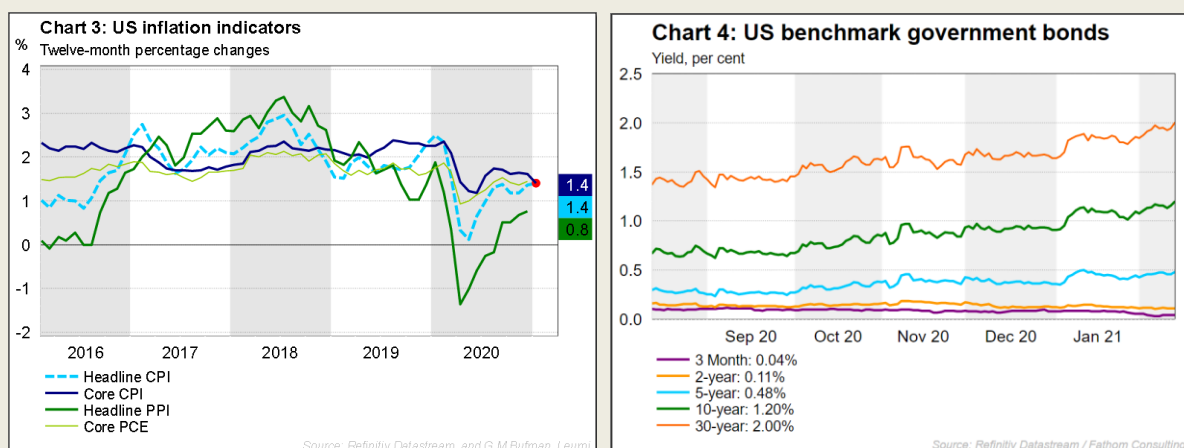


Inflation and monetary policy: the medium- and long-term forecasts of the Fed are more optimistic against the backdrop of the vaccinations occurring across the country, which are expected to lower the risks. The Fed is expected to continue its asset purchases throughout the year and consequently the Fed's balance sheet is expected to reach US\$9tn. The consumer price index (CPI) increased in December 2020, and in our opinion, the rate of price increases will pass the 2.0% target, during the coming year.

- The Fed's announcement following the January FOMC meeting emphasized that the economic recovery weakened in the final months of 2020, particularly the sectors negatively affected by the pandemic; however, the medium- and long-term forecasts of the Fed are more optimistic against the backdrop of the vaccinations, which are expected to lower the risks to the economy. The Fed statement explicitly notes, "the economic path is heavily dependent on the progress of the vaccination process". In addition, the Fed removed from its statement the phrase that the coronavirus represents a substantial risk in the medium-term. These changes indicate that the FOMC members have confidence in the vaccination process and that they expect this process will help to return economic activity to its normal functioning state.
- The Chairman of the Fed, Jerome Powell, was moderate and very cautious in the press conference, and he refuted the claims that the accommodative policy of the Fed has caused a rise in asset prices. The Chairman agreed that there are risks to financial stability due to the high asset prices; however, these risks are being dealt with by regulatory measures and not by means of narrowing monetary policy. The rise in the degree of volatility in the US stock markets illustrates the possibility that, in light of the relatively high level of stock prices, the degree of sensitivity of the market to various negative developments is greater than normal.
- In addition, the Fed Chairman sees no risks of a sustained rise in inflation, and in his view the apparent rise in inflation in 2021 should be considered as temporary, given the non-inflationary environment that has prevailed over recent decades. He further argued that it is too early to lower the support for monetary policy. We note that the Fed has recently committed to maintaining its rate of asset purchases until further significant progress is made in achieving price stability and employment targets. In our estimation, the Fed is not expected to reduce asset purchases before early 2022. As a result, the Fed balance sheet is expected to continue to rise, reaching a peak of US\$9tn, more than double its pre-pandemic size, and an interest rate hike is expected to occur only after a reduction in purchases will be initiated.
- The CPI increased 1.4% in January 2020 (y/y, see Chart 3), primarily due to a 7.4% (m/m) increase in the gasoline component, after in December it had increased by an annual rate of 1.4% as well, compared with the November index which rose at an annual rate of 1.2%. Core inflation declined in January to 1.4% (y/y) after it remained at an annual rate of 1.6% in December, which implies that price pressures still remain weak. In our opinion, the continued increase in the crude oil price is expected to lead to an increase in the gasoline price in February as well and the core inflation rate is expected to increase during the year to over 2.0%, which is the average level of the inflation target of the Fed. This will come against the backdrop of a rise in commodities prices, together with an increase in sea freight prices, which reflects a change in consumption patterns in the developed economies, with an emphasis on

the purchase of consumption goods and a decline in the consumption of services. However, the impact of the rise in demand for consumption goods, together with the rise in sea freight prices, on the inflation rate is expected to be moderate, since the consumption basket includes many services, whereas the consumption of goods has a relatively low weighting.

- The yields-to-maturity of government bonds rose in the first half of January, after in the second half of December 2020 the yields of long-term bonds increased more moderately (see Chart 4). The increase occurred in parallel to the continuing rise in the US stock market, and was supported by the asset purchases of the Fed, which purchased US government bonds and mortgage-backed securities (MBSs). Markets expect the Fed to continue its asset purchase program throughout 2021. The strong real investment data in the third and fourth quarters of 2020 support a continued rise in the yields-to-maturity of medium- and long-term bonds, and in our opinion these are expected to continue to climb during the coming year to 1.5% in 10-year to maturity bonds. The rise in yields-to-maturity in 2021 is expected to be partial, and not to reflect the full intensity of the underlying conditions, given the large degree of intervention of the Fed in the markets, and particularly in the government bond market.



The Euro Bloc

Economic activity: euro bloc GDP contracted in the final quarter of 2020 as economic restrictions tightened in many areas. GDP in Germany and Spain increased slightly in the fourth quarter of 2020, but the GDP of Italy and France contracted. Continued spread of morbidity, coupled with a slow vaccination rollout, will hamper the economic recovery of the euro bloc.

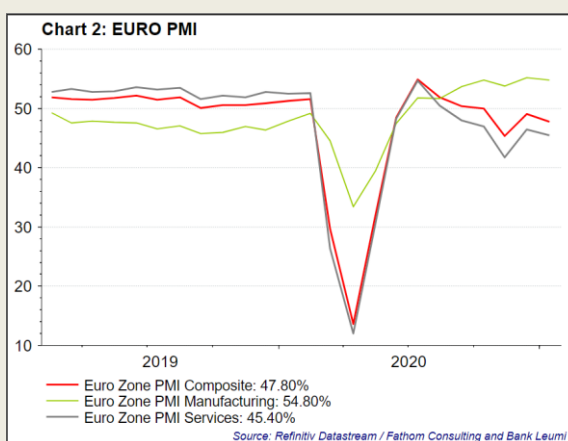
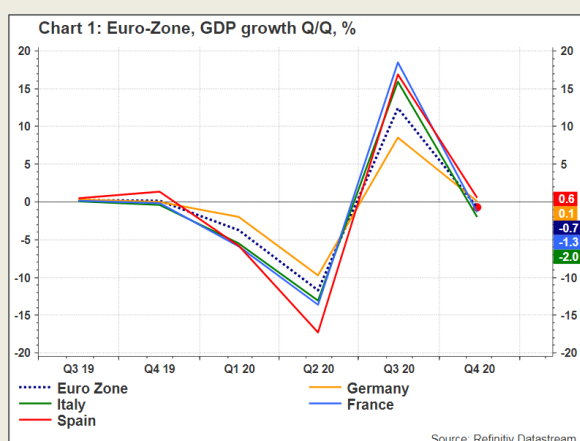
- The GDP of the euro bloc contracted 0.7% in the fourth quarter of 2020 (q/q, see Chart 1). The preliminary estimate indicates household consumption declined substantially, due to the tightening of restrictions in a large number of regions. In contrast, real investments increased, led by investments in the construction sector. High morbidity in the euro bloc is expected to delay the lifting of restrictions, with a further tightening in restrictions even possible in some

areas, and this is expected to hamper the recovery in the economic activity of the euro bloc against the backdrop of the slow vaccination rollout.

- Economic activity in the euro bloc weakened slightly throughout January due to the spread of the virus, which led to a tightening in restrictions across broad regions. The services sector has suffered the most, which has been the case until now whenever social-distancing restrictions have tightened. However, indicators show that the recovery in the industrial sector is continuing despite a decline in business confidence in the beginning of 2021. Industrial manufacturing in the euro bloc increased 2.5% in November 2020 (m/m), primarily due to strong growth in Ireland; however, the industrial manufacturing of the euro bloc excluding Ireland remained similar to October's level.
- Germany succeeded, as expected, to prevent economic contraction in the final quarter of 2020, as the country's GDP actually increased slightly by a rate of 0.1% (q/q). This was with the support of goods exports and investment in the construction sector, together with growth in industrial manufacturing in October-November. Italy suffered more heavily in the last wave of the spread of the virus than the other large economies of the euro bloc, as its GDP contracted 2.0% in the final quarter of 2020 (q/q). The GDP of France declined in the final quarter of 2020 by 1.3% (q/q) due to severe restrictions implemented in the country. The high morbidity in the country apparently will lead to a continued tightening in the restrictions and will weigh on the recovery in economic activity in the first quarter of 2021. In Spain, GDP increased in the final quarter of 2020 despite the restrictions imposed within the country. This comes in contrast to the consensus forecast that expected a contraction in Spanish GDP in the final quarter of the year.
- The composite PMI of the euro bloc declined in January (see Chart 2), indicating the negative impact on economic activity resulting from the tightening of restrictions and the imposition of economic shutdowns in some countries. The index indicates a contraction in economic activity in the services sector, together with a slowdown in the industrial sector, which is likely to lead to a contraction in GDP in the first quarter of this year. Furthermore, the economic sentiment indicator (ESI), which gauges the euro bloc business environment, also fell slightly in January, mainly due to a decline in the component measuring the business sentiment of non-essential retailers, since they were substantially hurt as a result of the tightening of restrictions. The decline in the ESI occurred despite the increase registered in the sentiment of the industrial and construction components of the index.
- The composite PMI of Germany fell in January to its lowest level in the past seven months, mainly due to a decline in the industrial sector PMI. However, the index of the industrial sector remains at a level that indicates continuing growth of industrial manufacturing, albeit at a slower pace. The IFO business climate index in Germany declined in January against the backdrop of tightening restrictions in the country that are likely to cause a contraction in the GDP in the first quarter of 2021 and to slow the strong recovery in industrial manufacturing. Unsurprisingly, a sharp drop was registered in the retail sales component of the index, which reached its lowest level since May 2020. This occurred because a large number of non-essential retailers closed due to the economic shutdown imposed in the country. In France, the composite PMI fell in January due to a decline in the index of the services sector that

offset the increase of the industrial sector PMI, and in Spain the PMI of the industrial sector declined in January from 51.0 to 49.3 points, indicating a slowdown in the industrial sector.

- The rise in morbidity in Spain will apparently lead to a tightening in restrictions, as occurred in other euro bloc countries, and this is likely to weigh on economic activity in the first quarter of this year. We expect that activity will start to recover later in the year in the event the vaccination of the population in Europe will occur according to plans, with the cooperation of the population. Such a development will enable the return of economic activity. However, in the event the vaccination of the population will continue to progress slowly, then the removal of restrictions is expected to be delayed, which will hamper economic activity particularly in Italy, Spain, Greece, and Cyprus. These economies are dependent on summer tourism, such that they are likely to be more harmed than the economy of Germany. We note that the restrictions imposed in Spain were less severe than those imposed in other euro bloc countries. Thus, for example, in Madrid it is permitted to sit in bars and restaurants during the day, in contrast to the situation in other euro bloc countries in which the tightening of restrictions prohibited such activity.
- Looking ahead, the IMF expects that the GDP of the euro bloc contracted 7.2% in 2020, while growth is expected to reach 4.2% in 2021. Among the four largest economies of the euro bloc, the IMF expects the GDP of Spain will grow by the highest rate in 2021, at 5.9%, whereas Italy will grow by the lowest rate, at just 3.0%. Germany is expected to be the only country among the four largest euro bloc economies that will see its GDP return in 2022 to the level it was at back in 2019, while the GDP levels of Italy, Spain, and France are not expected to return to their 2019 levels before 2023.
- The IMF expects that the public debt as a percentage of GDP of the euro bloc will rise in 2021 to 99.0%, while the public debt rate of Italy will equal 159.7% of GDP, and the rates for Spain and France will equal 118.9% and 117.6%, respectively. These rates of public debt are slightly greater than the rates of these countries in 2020. Germany's debt ratio is lower than that of Spain, France and Italy and is expected to have increased to 73.3% of GDP in 2020 from 59.5% in 2019. The public debt ratios of Italy, Spain, and France are substantially higher than their historic debt rates, even in times of crisis, while that of Germany is low relative to the rate it was at during its peak in 2010, following the global financial crisis.

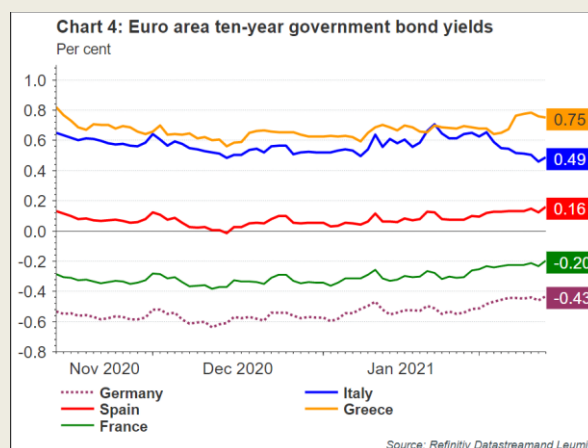
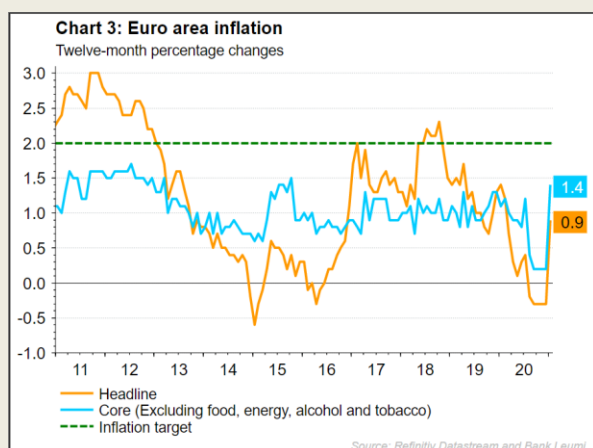


Inflation and monetary policy: the ECB kept its monetary policy unchanged, and the central bank estimates it will take time for the population to be vaccinated, which also has implications for the resolution of the crisis. The consumer price index (CPI) increased sharply in early 2021. Long-term government bond yields increased slightly in January, with a temporary emphasis on Italian government bonds due to political instability.

- At its January meeting, the ECB kept its monetary policy unchanged and the head of the ECB, Christine Lagarde, emphasized that she expects the interest rate to remain at the current low level until inflation will reach its target. In addition, the ECB repeated to emphasize the December 2020 monetary decision, in which the central bank expanded the Pandemic Emergency Purchase Program (PEPP) by €500bn, bringing the total sum of the emergency purchase program to €1,850bn. Also in that December 2020 decision, the ECB extended the horizon for net purchases under the PEPP, and also three additional rounds were added to its Targeted Longer-Term Refinancing Operations (TLTRO III) plan. The ECB expects that the start of the vaccination of the population increases the confidence in the resolution of the health crisis, but it will take time for a significant part of the population to be vaccinated, and other adverse developments related to the pandemic cannot be ruled out.
- An ECB survey indicates that demand for business loans, with an emphasis on long-term loans, declined in the final quarter of 2020 compared to demand in the first economic shutdown in the first half of last year. At the same time, banks tightened their credit terms, even though some of the loans were granted with government guarantees. Without these guarantees, the banks would have tightened the terms even more so, against the backdrop of the prevailing uncertainty in the economy with the continued spread of the virus. Meanwhile, the tightening of credit terms for small- and medium-sized businesses was more severe than for larger businesses. In parallel, household demand for loans for consumption fell, but demand for housing loans increased. This combination of developments is expected to cause the ECB to maintain its very accommodative monetary policy in order to support economic activity. In the event credit terms in the economy will be tightened further, we estimate the ECB will expand the TLTRO plan, and may even ease its terms such that they will be even more generous, before it will lower its interest rate to a negative level.
- The consumer price index used in the euro bloc, the harmonized indices of consumer prices (HICP), increased in January from the negative level it had been at over the last four months, -0.3%, to 0.9%, while the annual rate of core inflation increased from its low level of 0.2% to 1.4% (see Chart 3). Part of this increase stems from the cancellation of the temporary cut in Germany's VAT rate that led to an increase in the inflation rate in Germany, which rose in January from a negative annual rate of -0.3% to 1.0%. Only a small portion of the increase in the HICP stems from the rise in energy prices. In our estimation, the inflation rate is likely to rise during the coming months due to increasing energy prices, such that it is possible the core inflation rate will approach the ECB's target inflation rate, which is slightly below 2%, but in the medium-term, inflation is expected to be below the target.
- The yields-to-maturity of the government bonds of the large euro bloc economies increased slightly in January, with Italian government bonds showing the greatest increase (see Chart 4). This comes against the backdrop of the resignation of the prime minister of Italy,

Giuseppe Conte, which undermined political stability. Apparently, Conte failed in his attempts to form a new government and the president of Italy is examining whether another candidate will succeed in forming a government, while avoiding new elections during the pandemic.

- The president of Italy turned to Mario Draghi, the former president of the ECB, to see if he will be able to form a national unity government. In the event Draghi will succeed to form a government, this is expected to have a positive impact on the Italian economy due to his extensive economic experience. This is especially because the government must reach an agreement with the European Union (EU) on a €200bn plan within the framework of a general EU plan that is intended to assist EU member countries harmed by the current crisis, and as a result of this Italian government bond yield are expected to decline slightly. In our view, whether Mr. Draghi succeeds to form a government or not, during the coming year the supportive policies of the ECB are expected to continue to keep Italian government bond yields at relatively low level in order to reduce the potential for an increase in financial pressures.



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
<http://english.leumi.co.il/Home/>