Israel
Economic and Financial Review

March 6, 2014 / Issue No.278

Summary

- Economic .Indicators show that growth increased to some extent during recent months. The Manpower Survey for January revealed a large increase in payrolls and stability in the unemployment rate at a level of 5.9%. The labor force participation rate also increased, and is now at a record level of 64%.

- As in most developed countries, inflation environment is very low. In view of the improvement in the fiscal situation, taxes might be cut during the coming year, which could trim inflation slightly, and the appreciation of the shekel is also holding back price increases. We expect the CPI to rise by 1.5% in the next 12 months.

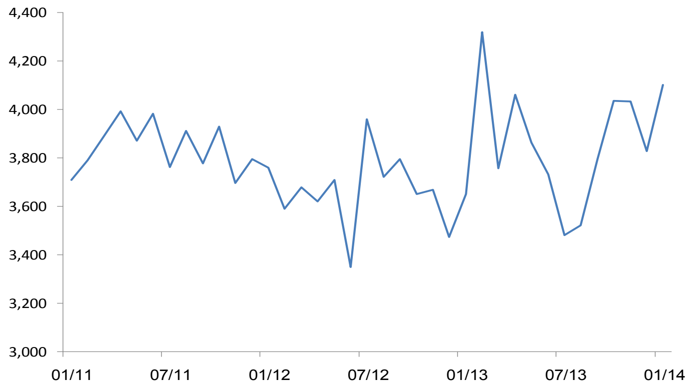
- We assume that the interest rate will remain at the level of 0.75% in the coming months. If appreciation pressures increase, or if weakness in economic indicators is apparent, the possibility of another rate cut cannot be ruled out.

Portfolio Strategy

- Overall macro Moderate levels of profit-taking in the stock market may occur in the short term. Overall however, macro data are still supportive of the equity market. We believe that exposure to corporates via stocks rather than corporate bonds is still advisable.

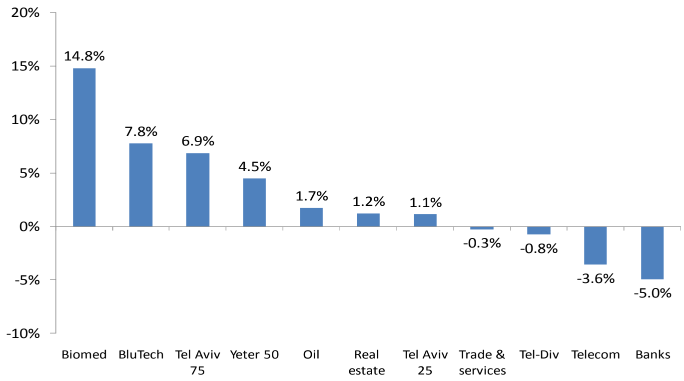
- With unindexed shekel bonds, we recommend investment in fixed-rate bonds at a medium duration and continuing to gradually combine these with a moderate amount of floating-rate bonds.

Growth in industrial exports
$ M. a month, seasonally adjusted



Source: CBS

Tel Aviv stock index returns
Year-to-date and up to 3.3.14



Source: Tel Aviv Stock Exchange

Advisory and Research Division
P.O.B 27, Tel Aviv 61000
Tel: 972-3-5675269

Economics Department
P.O.B 27, Tel Aviv 61000
Tel: 972-3-5674446

bank hapoalim

Global view

Doubts have been raised since the beginning of the year regarding a continued improvement in growth rates in the developed countries, especially in view of the increased level of risk in the emerging markets. Those economies are currently subject to political and economic uncertainty, as is clearly apparent from developments in Ukraine and Turkey. Meanwhile it should be noted, the impact on the financial markets has been limited. In the USA, economic data for the past two months have been disappointing and it is still too early to determine whether this is the result of the bad weather there or a change in trend and a move to a downturn. In the eurozone, indicators have been generally good although deflation is still a concern there. The absence of inflationary pressures in the developed economies and the state of the labor market ensure that interest rates in the West will remain low for the whole of 2014 and most likely beyond that as well.

A number of emerging markets are currently going through a difficult, if not a crisis period. The situation in this respect is worst in Ukraine. Even if the situation does not deteriorate into an actual war, the growing crisis between Russia and the West over events in the Ukraine could in certain scenarios hit global economic recovery as well. The main way in which this could be felt is Europe's heavy dependence on natural gas from Russia via Ukraine. The economic situation of Russia itself is giving cause for concern because it is a large importer of consumer goods from Europe. Looking ahead, the risk to global economic recovery will be focused increasingly in the emerging markets. The downturn in these countries' growth rates is not such a serious problem as the outflow of capital from those countries, and the accompanying decrease in leverage. The central banks there are adopting a policy of monetary restraint and their growth forecasts are declining.

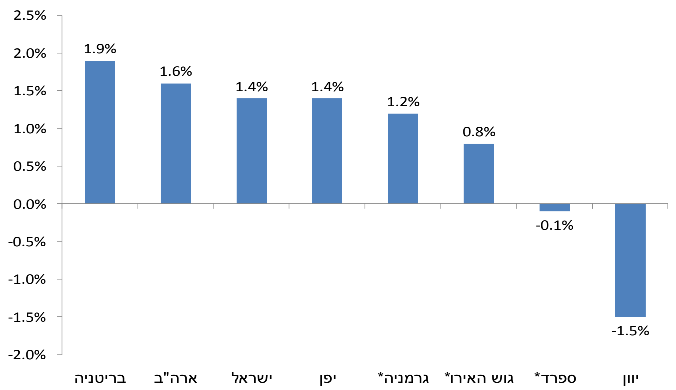
Israel: Economy and Policy

Indicators show that growth increased to some extent during recent months. Foreign trade data show a rise in industrial exports as well as in imports of goods, a 7% increase in credit card purchases during recent months, an annualized 2% expansion in the revenues of the principal industries according to trend data and a rise in the Purchasing Managers Index for the manufacturing sector to almost 50 points, the level distinguishing between activity expansion and contraction. Although growth in the fourth quarter of 2013 amounted to only 2.3%, exports, investment and even private consumption rose appreciably in that quarter. Since growth was held back by a decline in inventories, we do not believe that this can be taken as evidence of a downturn in growth.

The Manpower Survey for January revealed a large increase in payrolls and stability in the unemployment rate at a level of 5.9%. The labor force participation rate also increased, and is now at a record level of 64% (in the 15+ age group). During the last twelve months, the number of payrolls rose by 3.6%, more than the GDP growth rate, which may

Low inflation in developed markets

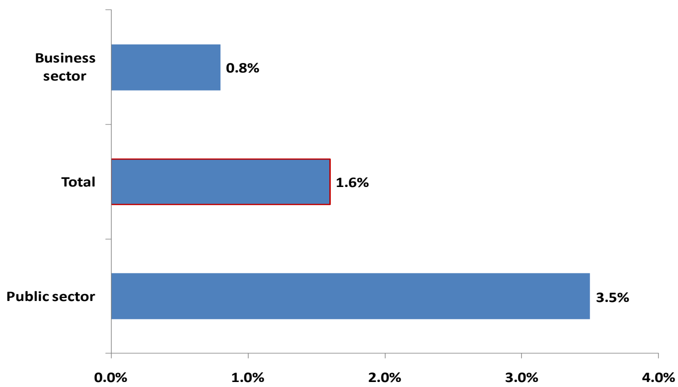
yoy change



Source: Bloomberg

Payroll additions mainly in the public sector

Rate of change, Dec. 2013 vs. Dec. 2012



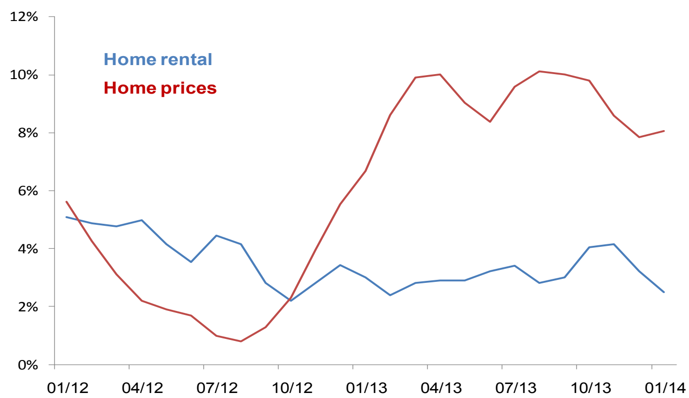
Source: CBS

indicate that labor productivity is not growing.

Is the real estate market cooling down? Purchases of new apartments fell by 9% in December and January on a month-on-month basis. Since only two months are involved here, it is not possible to know whether this resulted from the Bank of Israel's restrictions on mortgage takers and the Finance Minister's taxation regulations applying to investors. Home starts totaled 44 thousand units in 2013, a level that has remained quite stable for the past three years. The Central Bureau of Statistics' Apartment Price Survey showed a continued increase in apartment prices, by 8.1% in the past year. The increase in rental prices actually became more moderate, at 2.4% in the past year. The differential between apartment prices and rental prices has therefore continued to expand.

Inflation is still falling. The consumer price index for January fell by 0.6%, double the forecast rate. The two items that showed a surprise decrease were housing (apartment rental prices), which were down by 0.6%, and food prices, which dropped by 0.8%. As in most developed countries, the inflation environment is very low. The housing item (apartment rental prices), which to date had contributed to a rise in inflation, is now also rising to a more moderate extent. Although indicators show that while growth increased to some extent, this was not translated into wage pressures in the labor market. In view of the improvement in the fiscal situation, taxes might be cut during the coming year, which could trim inflation slightly, and the appreciation of the shekel is also holding back price increases. We expect the CPI to rise by 1.5% in the next 12 months.

Spread between home prices and rental fees is expanding Annual rate of change



Source: CBS

Surprising interest rate cut for March to 0.75%. The decision to cut the interest rate came as something of a surprise in view of the improvement in economic indicators, the continued rise in apartment prices and the halt to the appreciation of the shekel. There were two main reasons for the decision: The Bank of Israel attributed more importance to the decline in the inflation environment, resulting in the assessment that annualized inflation (looking back at the last twelve months) will approach the level of 1% in the coming month. The other factor is the prevailing thinking at the Fed and at the European Central Bank, which is affecting policy-makers' decisions at the Bank of Israel. The Bank of Israel's interest rate decision placed an emphasis on slightly different aspects than those in its previous decisions. Looking ahead, we do not expect a change in the underlying factors determining the level of the interest rate, and home prices are a major consideration. Neither is there any certainty that the interest rate is weakening the shekel, since foreign investors are hardly present at all in the fixed-income market in Israel. We assume that the interest rate will remain at the level of 0.75% in the coming months. If appreciation pressures increase, or if weakness in economic indicators is apparent, the possibility of another rate cut cannot be ruled out. At present, the risks surrounding the interest rate forecast derive from concern over a further interest rate cut rather than a rate hike,

The Local Equity Market

The year 2014 started out on the right foot. After the last third of 2014 had yielded favorable returns in the local equity market, 2014 started out on the right foot. The blue chips indexes rose during the first two months of the year. Particularly notable were second-line stocks, with the Tel Aviv 75 Index showing a gain of 8%. For the sake of comparison, the Tel Aviv 25 Index rose by only 1.6% in the same period, and the Yeter 50 Index, which starred last year with a yield of 36%, made do with a year-to-date increase of 4.3%.

Concurrent with these gains, the stock market continued to benefit from turnover growth compared with last year. Year-to-date, daily turnover has averaged NIS 1.2 billon compared with a low of less than NIS 800 million in the months July-August last year. Investors' sense of security was apparent as well. The local Fear Index, consisting of the implied volatility of Maof options, remained in the region of only 10%, indicating that investors regard a sharp fluctuation in the market as unlikely in the short term.

Forecast company results – a moderate improvement is expected. Annual reports for 2013 began to appear in February and their publication will continue until the end of March. We expect these reports to present erosion in aggregate profitability for the fourth quarter of 2013 as well, in line with the trend typical of the first three quarters of that year.

Looking ahead to 2014, we estimate that companies' results in the coming year will be mixed, with the general picture reflecting a modest improvement in profitability compared with 2013 in accordance with the performance of the local and the global economy. However, we do not expect any significant upturn in companies' results in view of the special challenges facing the sectors to which most of the companies comprising the Tel Aviv 25 Index belong. With respect to specific sectors, we expect a positive trend in the results of the large companies in the food and energy industries, while the other sectors will present a mixed trend for the year as a whole. It should be noted that we are referring here to companies' forecast business performance and not to the returns that will be produced on their stocks, although companies' results do of course have a considerable impact on the value of their stocks in the marKet.

The trend in the local stock market was favorable in recent months, leading to a yield of up to 8% in the blue chip indexes since the beginning of 2014. These gains, which are maintaining the positive wave of the last third of 2013, are increasing the risk of profit-taking in the short term. Looking ahead to 2014 however, we expect the year as a whole to be favorable for investors in the stock market, with moderate gains.

Exchange rates remain a burden for Israeli exporters and it should be remembered that over half of the Maof companies' revenues derive from abroad. Moreover, the future P/E ratio of the Tel Aviv 100 companies is higher than the multi-year average. Since an increasing number of stocks are now approaching their economic price, the potential for a further upside is limited. In addition, we expect an only moderate rather than a significant improvement in the overall performance of local companies in 2014. The micro situation is currently becoming clearer as company reports for 2013 are published, together with their management's objectives for the coming year. However, the local economy, including domestic demand, has shown signs of improvement in recent months. If this trend continues we believe, it will favorably affect the results of large publicly-traded companies, albeit to a moderate extent. As a result of the low interest rate in the economy, yields on alternative forms of investment are unattractive and liquidity surpluses in the market are continuing to flow towards equities. This could also have a favorable effect on the discount rates used in assessing companies' value.

Accordingly and as stated, we believe that the stock market could see a moderate amount of profit-taking in the short term. However, overall macro data are still supportive of the equity market. Exposure to corporates via stocks rather than corporate bonds is still advisable because of the preferable risk/opportunity ratio resulting from the relatively low yields on those bonds. Preference should still also be shown for indexes, principally the Tel Aviv 75, rather than individual stocks when adopting an equity position. The implied volatility of Maof options remains relatively low, enabling investors to purchase a

defense strategy and exposure to the equity market by means of this instrument at a relatively convenient cost.

The Fixed-Income Market

The year 2014 began with gains in government bonds and corporate bonds as a result of the fall in yields on US treasuries and the cut in the Bank of Israel interest rate to

a level of 0.75%, which came as something of a surprise. During January and February, 22 series of corporate bonds at a total amount of NIS 5.8 billion were issued. A third of this amount was issued for the purpose of replacing the issuers' shorter-term series, a trend that began back at the end of 2013.

Unindexed shekel bonds

Retain a large liquidity component and a medium duration

T-bills/Liquidity: The Bank of cut left the interest rate for March to a level of 0.75%. The T-bill for a year is trading at a yield of 0.75%, implying an interest rate of 0.75% in a year's time. **The T-bill remains a good alternative for liquidity purposes.**

Floating-rate bonds: Despite the relatively small yield increments above T-bills, a modest amount of floating-rate government bonds and corporate bonds can be gradually included in the portfolio.

Fixed-rate bonds: Yields on Shahar bonds fell along the entire curve during the past month (1.98% at a duration of 4.5 years, and 2.33% at a duration of 5.3 years). The yield on 10-year US treasuries fell to 2.65%, and the slope of the unindexed shekel yield curve decreased to 2.50%. The yield spread between 10-year Israel government bonds and their US counterpart contracted to 77 basis points. **We recommend investment in this component at a medium duration.**

CPI-indexed bonds

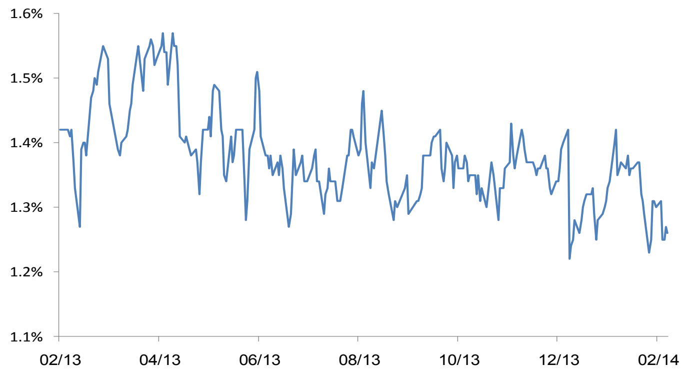
Short-term CPI-indexed bonds (up to 2 years)

The consumer price index for February is expected to fall by 0.3% and in the March forecast is expected to rise by 0.2%. The inflation forecast for 12 months ahead is 1.5%. Break-even inflation on short-term CPI-indexed bonds (up to 2 years) also amounts to 1.5%. Exposure to the short term by purchasing corporate bonds rated at A and above is recommended.

Medium and long-term CPI-indexed bonds

Break-even inflation on medium and long terms is in the region of 2.2%. **As a rule, we favor investment in these bonds at a medium and long duration (5 years +), with special emphasis on the individual investor's risk profile. The Tel Bond 20 and 40 indexes imply an internal yield of 1.10% and 0.95% respectively. The spreads above government bonds of the Tel Bond 20 and 40 Indexes are at levels of 128 and 127 basis points respectively. The yield on the CPI-indexed Tel Bond Index is 1.03%, reflecting a spread of 136 basis points above government bonds.**

Development of Tel Bond 60 spread over government bonds



Inflation environment in Israel

Inflation in last 12 months	1.4%
Forecast rise in CPI for next 3 months	0.5%
Inflation forecast for 12 months	1.5%
1 year break-even inflation	1.5%
10 year break-even inflation	2.4%
Home price increase in last 12 months	8.1%

With corporate bonds, we believe that the level of spreads does not suitably represent the credit risk of certain companies.

To conclude, we recommend retaining a large liquidity component. With unindexed shekel bonds, we recommend fixed-rate investment at a medium duration, and a modest amount of floating-rate corporate bonds can still be gradually included in the portfolio. With CPI-indexed bonds, investment in government bonds at a duration of 5 years + is preferable, with special emphasis on each investor's risk profile, together with corporate bonds by selecting those with a rating of A and above which are notable for a high level of tradability, at a short-medium duration.