ISRAEL
Economic and Financial Review

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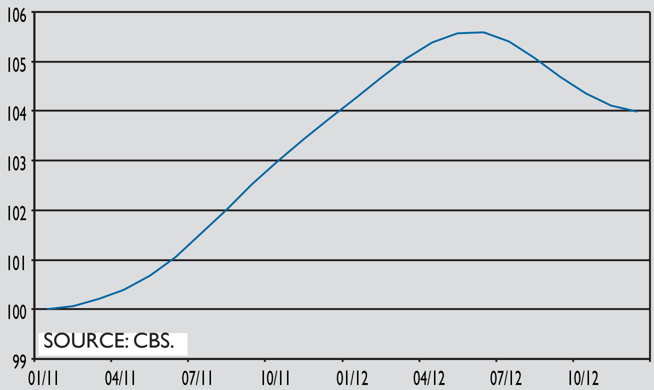
Summary

- Recent economic indicators show a further downturn in the growth rate. Although growth data for the fourth quarter of 2012 have yet to be published, it will come as no surprise if the growth rate for that quarter shows a decline to less than 2% annualized.
- is going to take a long time for the budget plans now appearing in the media to be finally approved-until a new government is formed and spending cuts are approved. Moreover, it is doubtful whether cuts can be made to an extent that will bring the budget deficit down to within the bounds targeted for 2013. This year's budget deficit is therefore likely to exceed 3.0% of GDP. We do not believe that a deficit on this scale will have an adverse effect on the capital market.
- It From the longer term perspective, an encouraging development is the State of Israel's highly successful issue of dollar bonds for ten and for thirty years, at relatively low spreads above US government bonds.
- It can be assumed that the housing market will be a major factor in the Bank of Israel's upcoming interest rate decisions. Meanwhile, since prices are rising again, the central bank will likely wait to see the outcome of the restrictions which it has imposed on the mortgage market. We believe that the interest rate will remain at its present level during the coming months.

Portfolio Strategy

- The level of uncertainty has increased in recent weeks, and we believe that it will continue to weigh down the equity market in the near future. Meanwhile therefore, we recommend maintaining a relatively low level of exposure in the equity component.
- We recommend focusing the portfolio on defensive stocks that are notable for stability in their activity. At the same time, we advise reducing the exposure to high-beta stocks.

Downturn in chain store sales
Jan. 2010=100, trend data



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

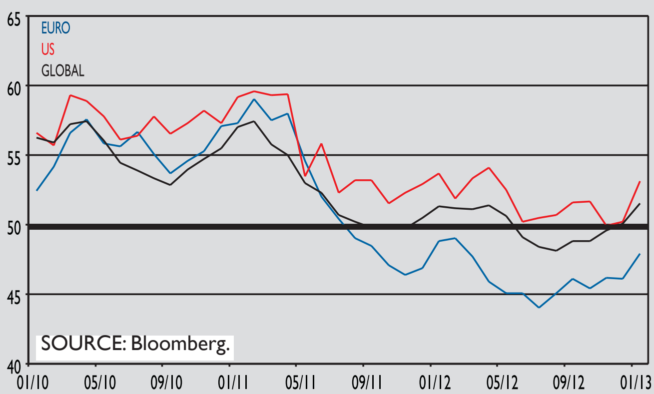
Hope is in the air. The global economy appeared to be more optimistic in the past month. This was apparent from the stock indexes and the confidence indexes that were published-most particularly worldwide PMI's, which showed a further expansion in manufacturing. The majority of economic indicators in the USA remain favorable. Although the issue of the US budget is still on the agenda, fears of a real crisis have abated. In the emerging economies and primarily China, an upturn in activity was recorded. In Japan, the new government is promising to adopt a more expansionary policy in order to encourage growth there. A more stable situation was apparent in the eurozone as well, and the region is expected to revert to a growth pattern as early as the second quarter of 2013. Although the IMF has slightly reduced its global growth forecast for the next two years, most economies are still expected to show positive growth. The global economy is expected to expand by 3.5% in 2013 following a growth rate of 3.2% in 2012. A contraction of 0.2% is forecast for the eurozone in 2013 and the German economy is expected to grow by only 0.6%.

Israel: The Economy and Economic Policy

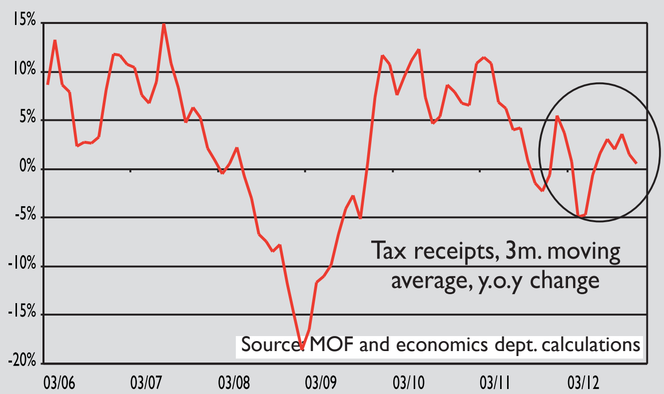
Recent economic indicators show a further downturn in the growth rate. These indicators were published at a time when growth in the developed countries appeared to be improving slightly, and the risk perception showed a significant improvement in both the local and worldwide capital financial markets. Although growth data for the fourth quarter of 2012 have yet to be published, it will come as no surprise if the growth rate for that quarter shows a decline to less than 2% annualized. Nearly all indicators show a downturn in growth: The revenue of the commerce and services industries and industrial production fell by 1.5% and 0.9% respectively. The marketing chains' sales dropped by 0.9%, and the Bank of Israel's Composite Index rose by only 1.3% annualized in the last quarter of 2012. We believe that the downturn in the Israeli economy at this point in time is a delayed response to the decline in global growth, and may also be connected to the measures taken to reduce the deficit, namely tax hikes, as well as to the uncertainty over economic policy measures after the elections. The unemployment rate was very stable in 2012 and the December figure amounted to 6.9%. The increase in the number of payrolls in the 25-64 age group slowed in the second half of the year to 1.5% annualized.

The budget deficit for 2012 rose to 4.2% of GDP compared with an original target of 2%. This result was known for months in advance and

Improvement in worldwide PMI's



The deviation of the deficit from the target derives mostly from the income side



surprised no one. Moreover, at the very beginning of the year, we estimated that at the present rate of growth, 2% of GDP will be missing on the tax revenue side alone. The deficit target for 2013 was set at 3.0% of GDP. This year's budget has not yet been approved, and the process has been postponed until a new government is formed. A cut estimated at 2% of GDP is necessary in order to adhere to this target. Meanwhile, the economic media is awash with reports of plans for budget cuts, tax hikes, the abolition of tax exemptions and cuts in allowances. It is going to take a long time for the budget plan now appearing in the media to be finally approved by the government—until a new government is formed and spending cuts are approved. Given the time now remaining, it is doubtful whether cuts can be made to an extent that will bring the budget deficit down to within the bounds targeted for 2013. This year's budget deficit is therefore likely to reach slightly less than 4% of GDP. We do not believe that a deficit on this scale will have an adverse effect on the capital market. In view of global conditions, neither is it likely to have an effect on Israel's debt rating. However, these assessments could change if the new government does not appear resolute in its attempts to cut the budget. At present, such a development is outside of our main scenario.

From the longer term perspective, an encouraging development is the State of Israel's highly successful issue of dollar bonds for ten and for thirty years, at relatively low spreads above US government bonds.

Low inflation expected in 2013 as well. The consumer price index rose by 1.6% in 2012. Relatively sharp changes in prices occurred in the past year, as the result of government policy. For example, mobile phone charges fell due to regulatory developments in the telecom industry and prices of child daycare centers plummeted due to the adoption of the recommendations of the Trachtenberg Committee for Socio-Economic Change. Concurrently, the increase in the rate of VAT led to price increases, such as in food products. We do not discern an upward pressure on prices at this stage, and inflation of less than 2% could have been expected in 2013. But since indirect taxes might be raised again this year, we forecast inflation of 2.0% for 2013.

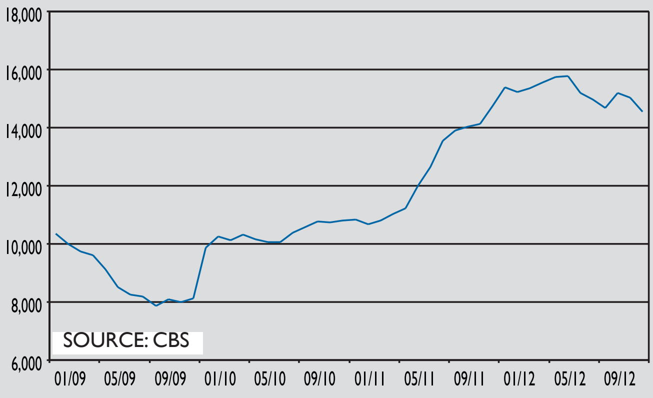
Vibrant demand for apartments in December as well. Sales of new apartments were stable in the second half of the year despite the restrictions which the central bank imposed on the uptake of mortgages. The Bank of Israel's most recent directive restricting the LTV ratio has not had any apparent effect to date, and is only likely to impact the housing market in the coming months. Since housing starts decreased during the past year and demand remained high, the average stock of apartments for sale fell from mid-2012. The Central Bureau of Statistics' Apartment Price Survey shows a relatively large price increase of 4.1% in the last four months.

The Bank of Israel left the interest rate for February unchanged at a level of 1.75%. The interest rate announcement was by no means pessimistic regarding the state of the economy, and did not include any kind of bias that might hint of the future course of the interest rate. As stated, we do not believe inflationary pressures exist, since activity has slowed. Nevertheless, it can be assumed that the housing market will be a

Inflation environment in Israel

Inflation in last 12 months	1.6%
CPI excluding housing (12 months)	1.3%
Forecast rise in index for next 3 months	0.1%
Inflation forecast for 12 months	2.0%
1-year break-even inflation	1.7%
10-year break-even inflation	2.6%
Apartment price increase in last 12 months	5.7%

The supply of new unsold apartments is down
New unsold apartments



major factor in the Bank of Israel's upcoming interest rate decisions. Meanwhile, since prices are rising again, the central bank will likely wait to see the outcome of the restrictions which it has imposed on the mortgage market. **We believe that the interest rate will remain at its present level during the coming months**.

The Equity Market

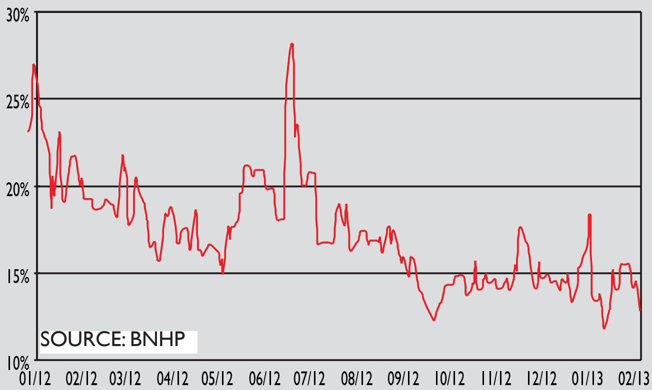
The year 2013 began in a climate of uncertainty in the local stock market. Apart from the signs of a downturn in the economy, uncertainty over the formulation of the new budget was another factor in this respect. The budget is expected to include measures which we believe will dampen domestic demand, and therefore also the performance of companies that themselves could suffer from a potential increase in the rate of corporation tax. Other elements of uncertainty that emerged in the course of the month were the question as to who will be the next Governor of the Bank of Israel, and the geopolitical situation in view of developments in Syria. As a result of the growing uncertainty, local equities posted losses during January as a whole, in contrast to the gains that were recorded in most of the world's major financial markets.

Relatively low volatility. Despite increased uncertainty, investors' sense of security still appears to be quite strong. Although the average implied volatility of the Maof (Tel Aviv 25) Index rose to a level of 20% in January, this was considerably less than the highs of over 30% which it reached in the past. Subsequently, implied volatility declined and at the beginning of February average only 12.5%, which as stated is indicative of investors' relatively strong sense of security in spite of the prevailing uncertainty.

Investors will wait for the reports season. Companies' financial reports for the fourth quarter and the whole of 2012 will come on line in February and will start flooding in by next month. Apart from their financial results in the past, many companies are expected to publish some really interesting data—analyses of target markets and the expectation of a strengthening of these markets in the present year. We estimate that the equity market will respond mainly to developments in the markets that will influence companies' performance during the coming year. It is believed that the companies reviewed from the Tel Aviv 25 Index will show a mixed performance compared with 2012. In our estimation, the overall picture will present an improvement in the aggregate profitability of the companies in the index. From the aspect of sector-specific distribution however, the variability between the different sectors will continue. We expect the telecom industry to continue suffering from a downturn, while an improvement can be expected in the food, energy and real estate industries. The other sectors will likely present a mixed trend in their results.

The year 2013 began with moderate losses in the local equity market despite the wave

Low volatility in TA25
Implied volatility



of gains which encompassed global equity markets. Uncertainty increased during recent weeks and we expect it to continue weighing down the market in the near future. Once the new government's economic policy becomes clear, and as companies' issue their forecasts for 2013 when their annual reports for 2012 are published, the level of uncertainty will decline to some extent. In view of the increased uncertainty that is however likely to prevail in Israel during the near future, at present we recommend maintaining a relatively low equity exposure, by holding 40% of the position defined, while noting the high level of risk in this component in the short term. From the aspect of sector-specific distribution, we recommend focusing the portfolio on defensive stocks that are notable for stability in their activity. At the same time, we advise reducing the exposure to high-beta stocks.

The Fixed-Income Market

The past month was notable for a slight increase in break-even inflation as a result of the unexpected 0.2% increase in the December CPI. Prices of unindexed and CPI-indexed government bonds fell, except among short-terms, which showed slight gains. Among other factors, the losses derived from the slump in yields, the downturn in the interest rate which is now coming to an end, and the rise in yields in the USA. A significant increase in issues was recorded in the corporate bond market. CPI-indexed corporate bonds showed slight gains while unindexed corporate bonds fell.

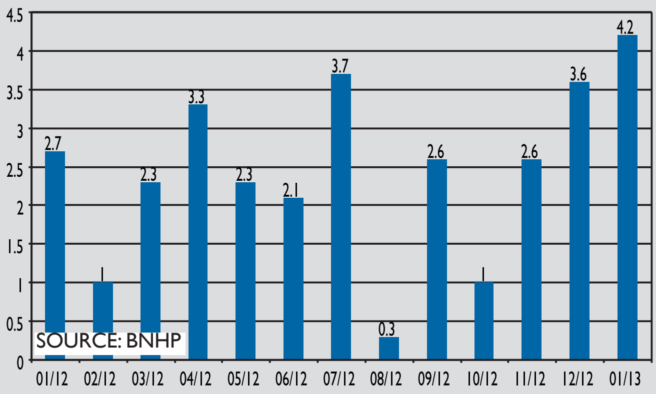
Unindexed shekel bonds - retain a large liquidity component and a medium duration

T-bills: The Bank of Israel left the interest rate for February unchanged at 1.75%. The T-bill for a year is trading at a gross yield of 1.7%. The T-bill remains a good alternative for liquidity purposes.

Floating-rate bonds: In view of the small yield increments above T-bills, we regard investment in floating-rate government bonds and corporate bonds as unattractive.

Fixed-rate bonds: Yields on medium and long-term Shahar bonds rose in January, to 2.6% at a duration of four years and 3.5% at a duration of 6.2 years. The yield on 10-year US treasuries rose sharply, to 2.01%. The yield spread between 10-year fixed-rate Israel government bonds and their US counterpart currently amounts to

Rebound in corporate bond issues
Non-financial issues, NIS billion



208 basis points. We recommend investment in this component at a duration of four years.

CPI-indexed bonds

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

Low inflation is forecast for the coming months: The January CPI is expected to remain unchanged and by March, the index is expected to rise by 0.1%. The inflation rate forecast for the next twelve months is 2.0%. Break-even inflation derived from short-term CPI-indexed bonds (up to two years) also amounts to 2.0%. In view of the low indexes forecast for the coming months, investment in short-term CPI-indexed government bonds is unattractive. Exposure to the short term can be made by purchasing corporate bonds rated at A and above.

Medium-term (2-5 year) CPI-indexed bonds

Break-even inflation for medium terms amounts to 2.5%. We do not regard medium-term CPI-indexed government bonds as attractive for investment. The Tel Bond 20 and 40 indexes currently imply yields of 1.68% and 1.69% respectively, reflecting a spread of 1.49% and 1.54% above CPI-indexed government bonds in each case. We recommend exposure to the medium term by means of the selective purchase of corporate bonds rated at A and above and with a high level of tradability.

Long-term CPI-indexed bonds

Break-even inflation on long terms is 2.6%. Investment in this component is recommended at a duration of 5-6 years.

To conclude, we recommend maintaining a large liquidity component. Since we believe that the downturn in the interest rate is close to an end and that the interest rate environment will remain low over time, we regard the potential for capital gains as low. In unindexed shekel bonds, we recommend investment at a short duration (as a liquidity substitute) and investment at a duration of four years. In CPI-indexed bonds, we recommend investment in government bonds at a duration of 5-6 years and at a long duration in accordance with the customer's desired level of risk, together with high-rated corporate bonds notable for a high level of tradability, at a short-medium duration.

Tel Bond spreads remained at a low level