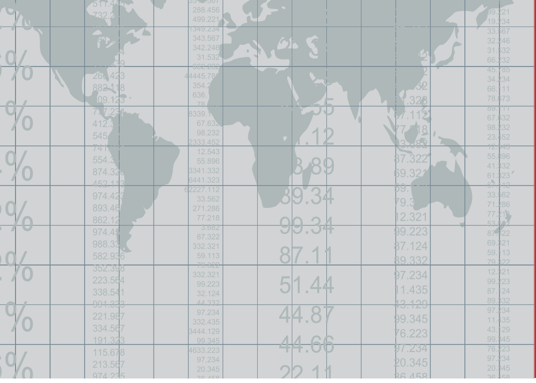

# ISRAEL
# Economic and Financial Review

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## Summary


- Three main factors are expected to affect economic activity in 2013: the moderate pace of global growth; fiscal policy, which is likely to be tighter than previously; and from the positive aspect, the flow of gas from the Tamar field, which is due to come online in the second quarter of the year.

- Without the positive impact of the gas production from the Tamar field, we forecast growth of 2.5% for this year, which is not much different from the rate prevailing in the second half of 2012. The growth rate including the effect of natural gas from the Tamar field is expected to reach 3.3%.

- It will take time for a new government to be formed and major decisions to be made, making it doubtful whether it will be possible to cut the budget deficit by as much as 2% of GDP. We therefore expect the deficit to reach 4% of GDP. A deficit on this level is unlikely to change Israel's credit rating or affect the financial markets.


## Portfolio Strategy

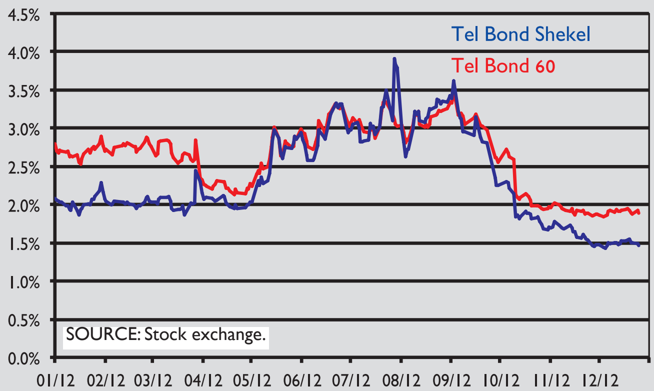
- We recommend focusing the equity holding on the stocks of value companies from defensive sectors oriented towards staples and notable for strong flows, while maintaining a minimal exposure to companies oriented towards private consumption in Israel.

- In the bond portfolio, we recommend investment at a duration of 4-5 years in unindexed shekel bonds, and in CPI-indexed bonds government bonds at a duration of 5-6 years. This should be done while including high-rated corporate bonds at short-medium duration and with a high level of tradability.

### Israel: Forecast summary for 2013

| | 2012E | 2013F |
|---|---|---|
| GDP growth | 3.3% | 3.3% |
| Per capita GDP growth | 1.5% | 1.5% |
| Business sector GDP growth | 3.2% | 3.7% |
| Private consumption | 2.8% | 1.8% |
| Public consumption | 3.7% | 3.3% |
| Gross capital formation | 3.7% | 0.3% |
| Exports of goods and services | 1.0% | 3.0% |
| Imports of goods and services | 3.2% | 0.0% |
| Unemployment rate (annual average) | 7.1% | 7.3% |
| Budget deficit (% of GDP) | 4.2% | 4.0% |
| Inflation | 1.3% | 2.0% |
| Bank of Israel interest rate (end of period) | 2.0% | 1.75% |

### Tel Bond spread closed the year at a low level





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## Global view

The outlook at the start of the year is optimistic: The fiscal cliff is behind us, the situation in Europe is now not quite so bad, and in China the growth downturn appears to have ended. However, the outlook appears less positive when it is remembered that in the absence of a solution for the developed countries' fiscal problems, public debts will continue to expand and threaten growth and economic stability.

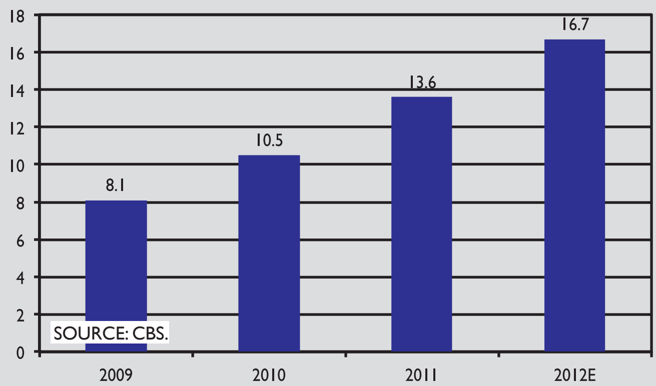
We expect global growth to remain at a low level of 3.4%. As in 2012, the growth forecast for the USA is 2.2%, while the recession in the eurozone economy will continue, resulting in a contraction of 0.5%.

If one thing is certain, it is monetary policy worldwide: Central banks' interest rates are expected to remain low during the whole of 2013. This abnormal situation has lasted for four years now, and clearly involves considerable risks from the long-term perspective.

## Israel: The Economy and Economic Policy

Waiting for natural gas from Tamar to boost growth. The Israeli economy expanded by 3.3% in 2012 according to the initial Central Bureau of Statistics estimate. A downtrend in growth rates was apparent throughout the year, and it can be assumed that growth was less than 3% in the second half of the year. (The Central Bureau of Statistics has yet to publish the figure for the fourth quarter). The main reason for the downturn was the slower rate of export growth against the background of the global situation. However, the downturn also reflects data on private consumption and investment in the economy. Three main factors are expected to affect activity in 2013: the moderate pace of global growth; fiscal policy, which is likely to be tighter than previously; and from the positive aspect, the flow of gas from the Tamar field, which is due to come online in the second quarter of the year. As regards the impact of the global environment on the economy, we do not expect any further deterioration. In other words, background conditions are much the same as last year. Although non-diamond exports rose by 4.2%, much of the increase derived from the contribution of Intel's new computer chip plant, and exports fell in most other branches of manufacturing. The positive effect of the chip plant is unlikely to be felt again in 2013. As regards fiscal policy, while this policy cannot be regarded as particularly tight considering that much of the growth in the budget deficit derives from the expenditures side, including wage expenses and other benefits, it can be assumed that the planned tax hikes will eventually have a contractionary

Imports of energy products
billion $



effect on the economy. As stated, the good news is that natural gas is scheduled to come online from the Tamar field. We will discuss the impact of this development later in the review. Without the positive impact of gas production from the Tamar field, we forecast growth of 2.5% for this year, which is not much different from the rate prevailing in the second half of 2012. The growth rate including the effect of natural gas from the Tamar field is expected to reach 3.3%.

Contribution of the flow of natural gas to growth in the economy. As can be seen from the graph below, imports of energy materials to Israel rose by nearly $ 3 billion in 2012. While part of the increase derived from the effect of high world prices for oil, it mainly resulted from the cutoff in the supply of natural gas from Egypt. On the assumption that natural gas from the Tamar field will come online in the second quarter, imports of energy materials can be expected to fall by a similar amount. Translating this into growth terms is dependent on the measurement methodology used: If most of the import saving is recorded as incremental GDP, the growth increment could reach 1% or more. If the market value of the gas produced is measured as incremental GDP, the contribution measured will be more modest. Apart from the import saving, we also have the positive effect of energy-intensive industries, which are expected to expand their activity. In the final account, we assume that the contribution measured will be high, at 0.8%. It should be noted that although the flow of gas will contribute to growth, it will have hardly any effect on employment and households' income.

The good state of the labor market continue to surprise us in 2012: The unemployment rate is stable at 7% and the number of payrolls has increased by 3.5%. Most of the new payrolls were in the public sector, in education and health services. We believe that relatively slow growth and business sector streamlining measures will together lead to a gradual increase in the unemployment rate to a level of 7.5%.

The budget deficit is expected to exceed the targeted level even after spending items are cut. According to Bank of Israel estimates, the government has taken on obligations of NIS 12 billion in excess of the planned budget for 2013. On the tax revenues side, we forecast a shortfall of NIS 5-8 billion with respect to the budget plan. This means that without fiscal cuts, the deficit will exceed the target by 3% of GDP and reach 5% of GDP. Any government that is formed will likely push through budget cuts and tax hikes in order to reduce the level of the deficit. We believe that it will take time for a new government to be formed and major decisions to be made, making it doubtful whether it will be possible to cut the budget deficit by 2% of GDP. We therefore expect the deficit to reach 4% of GDP. A deficit on this level is unlikely to change Israel's credit rating or affect the financial markets.

Inflation was lower than expected despite expansionary policy and the increase in indirect taxes. The consumer price index rose by 1.4% during the first 11 months of 2012. Since we expect the December CPI to fall by 0.1%, annual inflation for 2012 will amount to 1.3%. Government measures led to relatively large changes in relative prices. As an example, prices for nursery schools fell by over 70% when they became free of charge from the age of three, in line with the recommendations of the Trachtenberg Committee for Socio-Economic Change. Prices of mobile telephone services also fell, by 5%. However, the price of electricity rose by 10%, and prices of other staples were affected by the increase in indirect taxes. We do not forecast inflationary pressures

### Inflation environment in Israel

| | |
|---|---|
| Inflation in last 12 months | 1.4% |
| CPI excluding housing (12 months) | 1.1% |
| Forecast rise in index for next 3 months | -0.3% |
| Inflation forecast for 12 months | 1.8% |
| 1-year break-even inflation | 1.7% |
| 10-year break-even inflation | 2.6% |
| Apartment price increase in last 12 months | 3.7% |

in the short term. On the contrary, the recessionary environment is having the effect of reducing prices, and the upturn in housing prices (apartment rental) has ceased. The inflation forecast for 2013 is 2%.

Large 5% appreciation of the effective exchange rate of the shekel in the last four months of the year. The reasons for the appreciation included the reduced concern over an attack on Iran, and expectations of a change in the balance-of-payments trend once natural gas comes online in 2013. In addition, recent months have seen a slow resumption in foreign investors' purchases of bonds and T-bills after these investors had realized most of their holdings by mid-2012. The improvement expected in the balance-of-payments current account as a result of the flow of natural gas is considerable, amounting to $ 2.5 billion. However, this is not on a scale that could change the balance of forces in the foreign currency market, particularly when it is considered that not all this money will necessarily be converted to shekels.

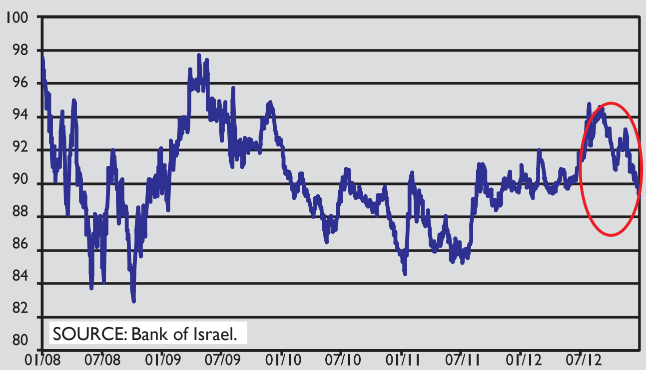
The global trend will likely continue to dominate monetary policy. The interest rate will remain low, like its level at the end of the year (1.75%). Considering the rate of growth, the state of the labor market and especially the state of the housing market, the interest rate appears to be too low, as is apparent from the renewed increase in housing prices. Since the world's central banks are adopting a highly expansionary policy, the Bank of Israel cannot do otherwise. The large appreciation of the shekel during the last four months was therefore also a consideration in reducing the interest rate for January. In 2012, the central bank took a number of measures in order to halt the growth in mortgage loans and cool down the housing market. The Bank of Israel has long since noted that the problem is on the supply side. Although it does not have the means to deal with this, it is reasonable to assume that developments in the real estate market will continue to be a major consideration in the bank's decisions in 2013 as well.

# The Equity Market

The year 2012 ended on the downside. Although 2012 ended with gains in the leading stock indexes on the local stock exchange, the market weakened again towards the end of the year. The year started out badly, with heavy losses in the main stock indexes. This trend was typical of most of the year. Due to the large gains recorded during the months September-November however, the returns became positive. Nevertheless and as stated, the year ended on a sour note because of the losses recorded in December, which nevertheless left the local market with quite good positive yields in comparison with Western markets.

Fall in trading turnover. Another trend notable during the past year was a decline in turnover. Turnover averaged NIS 2 billion a day in 2010 and in 2001 fell slightly, to a daily average of NIS 1.5 billion. In 2012, turnover contracted to a considerable extent, down to a daily average of only a billion shekels. This was the lowest daily average recorded on the local stock exchange since 2005. The fall in turnover resulted from a number of factors: the drop in turnover in equity markets worldwide; the losses in the local equity market, which naturally reduced investors' interest in it; geopolitical uncertainty; and the increase in capital gains tax at the beginning of 2012, which reduced investors' motivation to trade in equities. Once a sustainable rebound occurs in the equity market,

**Large appreciation of shekel in last four months**
Nominal effective exchange rate



we do however believe that turnover will recover as well, as we have seen in the past.

Mixed trend expected in companies' results in 2013 as well. At the start of the new civil year, we believe that the companies reviewed from the Tel Aviv 25 list will show a mixed trend in comparison with 2012. Overall, we expect an improvement in the aggregate profitability of the companies in the index. However, the variability between the different sectors will continue. The telecom sector will likely continue to show a downturn, while an improvement is expected in the food, energy and real estate sectors. In our estimation, the other sectors will show a mixed trend in their results.

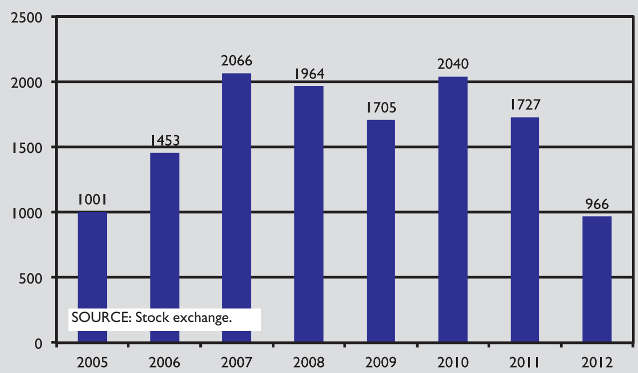
The performance of the companies traded on the Tel Aviv Stock Exchange is heavily affected by developments in the local economy, including: factors that affect growth; the state of the labor market; fiscal and monetary policy, foreign trade; and local consumers' demand. At the same time, developments abroad have a major impact on the local equity market. This effect derives from three channels: the effect of macroeconomic developments on the Israeli economy; the high degree of correlation between activity in global capital markets and the local capital market; and the fact that the proportion of global activity in Maof (Tel Aviv 25) companies' total activity has increased continually over the years. Accordingly, a rebound in the results of local companies is largely dependent on local and global macroeconomic developments.

The signs of downturn in the economy concurrent with expectations regarding the economic policy that will be formulated after the election, which will likely include spending cuts in view of the gaps in the budget, could weigh down the market in the medium term. However, the interest rate is still very low and companies' profitability is expected to improve in comparison with 2012, mainly due to weak comparative data and the streamlining programs which many companies have adopted. We therefore recommend maintaining the present level of exposure in the equities component, taking due account of the high level of risk in this component in the short term. We recommend focusing the equity holding on the stocks of value companies from defensive sectors which are oriented towards staples and notable for strong flows, and maintaining a minimal exposure to companies oriented towards private consumption in Israel.

## The Fixed-Income Market

The year 2012 was notable for gains in all the bond indexes, both government and corporate bonds. Contributing to this trend were the low inflation environment and the cumulative one percentage point reduction in the Bank of Israel interest rate during the year. Particularly large increases (over 11%) were recorded in long terms among unindexed as well as CPI-indexed bonds. Both forms of investment yielded similar returns except in the medium term, where unindexed shekel bonds were notable for their favorable performance. The yield spread between 10-year Israel Government bonds and their American counterpart contracted by nearly 50 basis points to the low level of 216 basis points. Corporate bonds rose as well: The Tel Bond Indexes gained an average of 9% and the unindexed shekel Tel Bond Index advanced 7.4%. The composition of the Tel Bond Indexes was changed in the course of the year. In the last adjustment, in October 2012, high-risk bonds were delisted from those indexes. Together with the gains in corporate bonds, this led to a

**Large decrease in trading turnover**
Average daily equities turnover on Tel Aviv Stock Exchange, NIS million



considerable decrease in the spreads above government bonds (at average level of 1.7%). Issues in the corporate bond market totaled NIS 30 billion. Of this amount, only NIS 8.5 billion were issues of new series (35 new issues) and the remainder derived from the expansion of existing series (slightly more than 100 issues).

In view of our assessment that the downturn in the interest rate is almost at an end and that the interest rate environment will remain low over time, we believe that the potential for capital gains in the long duration is low. In unindexed shekel bonds, we recommend investment at a duration of 4-5 years. In CPI-indexed bonds, we recommend investment in government bonds at a duration of 5-6 years and in the long duration, in accordance with the investor's risk preference. This should be done while including high-rated corporate bonds at short-medium duration and with a high level of tradability. We expect the corporate bond market to be volatile because of the continued uncertainty over issuers' ability to rollover their debt and any resulting significant debt arrangements.

## Unindexed shekel bonds

### Retain a large liquidity component and a medium duration

**T-bills:** At the present level of yields and given the expectations regarding the Bank of Israel interest rate, 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 as unattractive.

**Fixed-rate bonds:** Yields on medium and long-term Shahar bonds fell heavily in 2012. The yield on 10-year US treasuries amounts to 1.8%. The yield spread between 10-year fixed-rate Israel Government bonds and their American counterpart contracted by 50 basis points during 2012 to the low level of 216 basis points. We recommend investment in this component at a duration of 4-5 years.

## CPI-indexed bonds

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

Low inflation is forecast for the coming months: The December CPI is expected to fall by 0.1% and the January CPI by 0.2%. The inflation rate forecast for the next twelve months is 1.8%. Break-even inflation derived from short-term CPI-indexed bonds (up to two years) amounts to 1.9%. Investment in short-term CPI-indexed government bonds is therefore unattractive. Exposure to the short term can be made by purchasing corporate bonds rated at A and above.

### Medium-term (2-5 year)

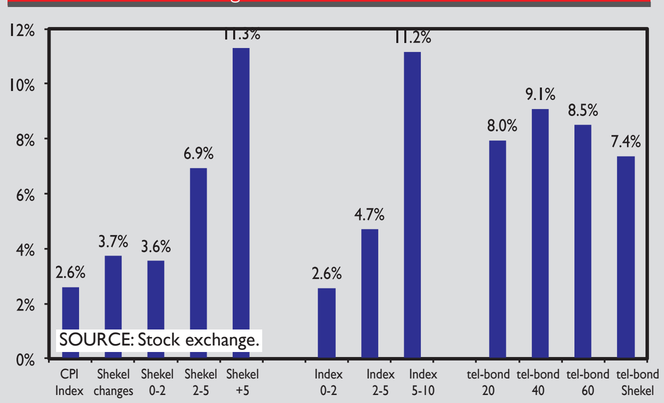
Break-even inflation for medium terms amounts to 2.45%. The Tel Bond 20 and 40 indexes currently imply yields of 1.67% and 1.58% respectively, reflecting a spread of 1.50% and 1.49% above CPI-indexed government bonds in each case.

### Long-term CPI-indexed bonds

Break-even inflation on long terms is 2.7%. Investment in these bonds is recommended for customers with a suitable risk profile.

Expansionary monetary policy boosted bond prices

Change in bond indexes in 2012

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