

Preparing to be revalued?

Shekel outlook into 2010

Summary

Currency markets in the last two years have been driven primarily by risk appetite with 'risky' currencies enjoying strong rallies in recent months as growth stabilises and asset markets recover. These same currencies were weak in the preceding 'crisis' period. The ILS has behaved as part of the former 'safe haven' group. It has risen 12% against the USD since the latter peaked in March, but has fallen by over 30% against the ZAR and the AUD, and 5-10% against GBP and EUR. Yet the Israeli economy has dramatically out-performed the G7 currencies with strong growth, low inflation, limited deterioration in public finances and very a healthy foreign trade position. The key is the outlook for monetary policy. If the Bank of Israel tightens policy in line with the economic recovery that is underway, the ILS will out-perform through 2010.

Economic Backdrop

The Israeli economy has had a relatively 'good' economic crisis. A very mild recession will see real GDP fall marginally this year, (by 0.1% according to the IMF) before rebounding to a 2.4% growth rate in 2010. That comes after an average growth rate close to 5% in the last five years, as the economy recovered from the 2001/2002 recession, over twice the growth rate of the major advanced economies and actually just ahead of the average of the newly-industrial Asian economies which are widely regarded as the 'stars' of the current economic cycle.

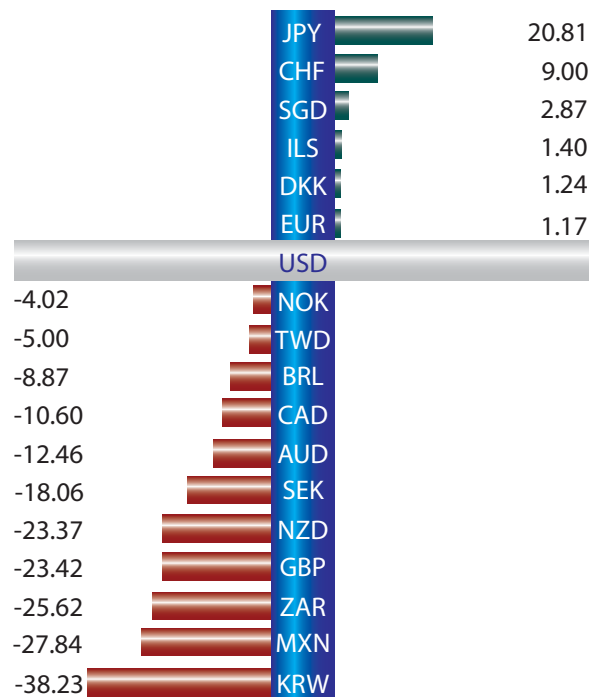
The Israeli economy started to recover in the second quarter of 2009 after two quarters of decline. Reasons for the relatively early bounce can probably be put down to four factors. Firstly, the Israeli economy is now very sensitive to global trade volumes and exports recovered very sharply in the second quarter. Secondly, healthy public finances after several years of fiscal restraint meant that the effects on the public sector balances of recession were relatively mild and have not exacerbated the downturn. Thirdly, having brought inflation under control and having seen the emergence of a sizeable current account surplus, the Israeli shekel was one of the world's strongest currencies in the two years prior to the collapse of Lehman Brothers, and a fall thereafter did not cause a balance of payments or inflation crisis, merely helping regain some competitiveness. Finally, Israel's banking sector has escaped the woes of the G7 economies, so that lack of credit availability has not been a barrier to recovery.

Looking forwards, there is substantial scope for upside growth surprises in 2010. A 3% growth rate next year seems plausible. That is entirely predicated on an optimistic assessment of the international environment, but there seem few domestic barriers to Israel benefitting from improving global conditions. That kind of growth rate would allow Israel to start reversing the 5% GDP budget deficit.

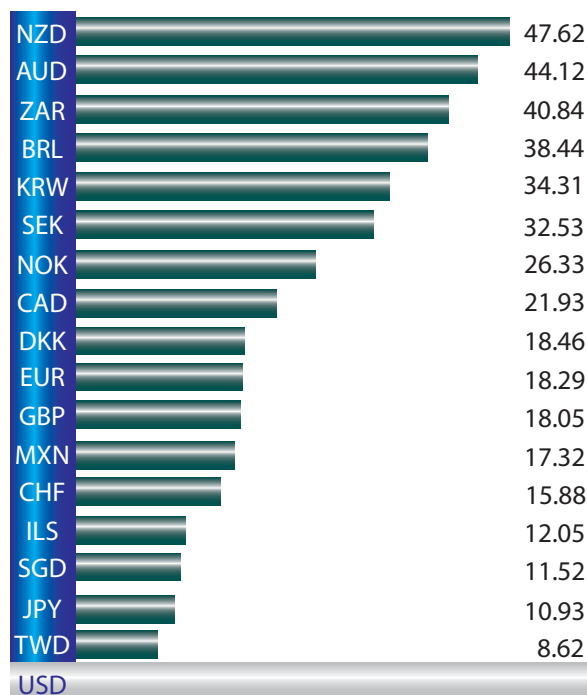
The challenge for Israel is mostly a policy one. Current levels of interest rates are far too low for the economic recovery which is underway. With a sizeable output gap, and a robust currency,

Currency moves vs. the dollar

11th October 2006 — 4th March 2009



4th March 2009 — 16th November 2009



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there is no rush to raise rates on inflationary grounds – CPI inflation will increase by around 2% next year. However, a nominal GDP growth rate of 5% is inconsistent with the current 0.75% policy rate. The quandary is — as is the case with any economy where growth is rebounding and the balance of payments is healthy — whether policy is constrained by the ILS.

Currently, the ILS market is priced for a rise in rates from 0.75% now to around 2.5% in a year's time and to about 3.75% in two years' time. That would still leave rates far below the average of the last few years. If the economy continues on its current path as the global recovery takes root, interest rates will need to rise substantially more than that and the Bank of Israel will have to accept the currency consequences.

The Shekel — up already but further to go

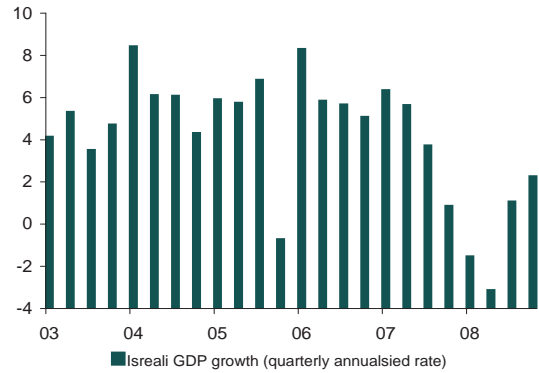
Since the USD reached its best levels of 2009 in early March it has fallen against all the other major currencies and most sharply against those outside the G7 where economic growth has been resilient to the credit crisis and where interest rates have risen this year. And yet, the ILS has fallen against all the major currencies with the exclusion of the USD, SGD, JPY and TWD over that period. This is despite the fact that there has been a very modest tightening in Israeli monetary policy, but the absolute level of rates is still at a very low level.

Within a global currency context, the ILS has behaved like other low-rate surplus economies' currencies. By that, I mean that in the period from October 2007 when equities peaked to March 2009 when they troughed, the strongest currencies in the world were the JPY, the SFR, the USD, the ILS and the SGD; all low-rate 'safe-haven' currencies. In the period since equities troughed, the focus has been on the 'higher-yielding' — and by association riskier — currencies, i.e., the NZD and the AUD, the ZAR and the BRL. Within this context however, Israel is a bit of an anomaly. Current account surplus (even a trade surplus now, for the first time in ages) low rates and a stable economy are all attractive safe-haven currency virtues. But the pace of economic recovery, which is more like that of non-Japan Asia, will increasingly be a factor — IF interest rates are adjusted appropriately for the economic cycle.

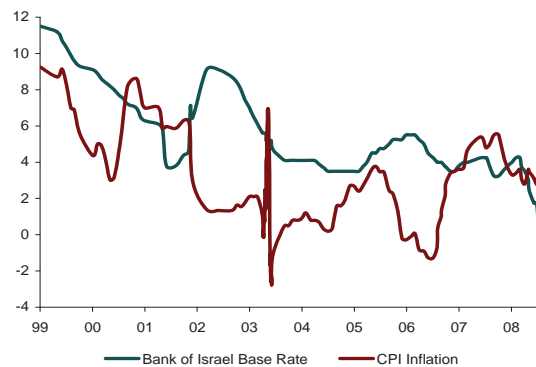
Prospects

Owning the ILS is a natural hedge for a return to crisis conditions on the basis of recent performance, but the currency has underperformed in the global trade and asset rebound. If rates do rise to economically appropriate levels, it will look increasingly like a relatively undervalued high-yielder. In other words, if rates do rise in line with the economic outlook, the shekel is less a hedge against renewed crisis and more likely to be seen as a cheaper way to benefit from the recovery in global trade than buying the already expensive AUD, NZD and BRL.

What recession?



Have rates fallen too far?



Kit Jukes

Chief Economist

The ECU Group plc

73 Brook Street
London W1K 4HX

t. +44 (0)20 7399 4600
kit.jukes@ecugroup.com

www.ecugroup.com



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