

Focus: Israel

Back to basics

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Israel remains one of the strongest fundamental stories in the region, in our view. We revisit the key arguments below. We remain short USD/ILS and long Shahar'16 bonds.

The world economy is delicately poised as markets digest the implications of the credit crunch. We do not agree with the view that emerging markets can fully “decouple” from trends in developed economies. Thus, we expect emerging market economies to differ markedly in their performance. Specifically, we think that economies with solid external balance pictures, strong domestic demand dynamics and competitive currencies should withstand global growth woes reasonably well. Israel ticks all of these boxes.

WHERE ELSE CAN YOU FIND THIS COMBINATION OF NUMBERS?

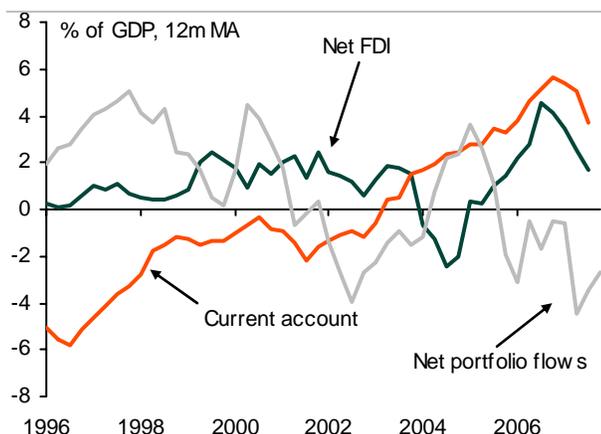
Israel’s fundamental story has been (and still is) very supportive. Consider.

Strongest balance of payments picture in the EMEA space...

Israel’s **balance of payments** picture, with FDI and the current account combining for a surplus of close to 7% of GDP (Figure 1), is easily the strongest in the EMEA region and in EM as a whole. And Israel’s current account surplus of close to 4% of GDP is especially notable considering that Israel is a net commodity importer. And, on our own measure of external vulnerability – Damocles – Israel has the lowest possible score: zero¹. Although the current account surplus has passed its peak and will likely continue to fall as the trade balance moves further into red on the back of buoyant domestic demand, the balance is still likely to remain very healthy for now.

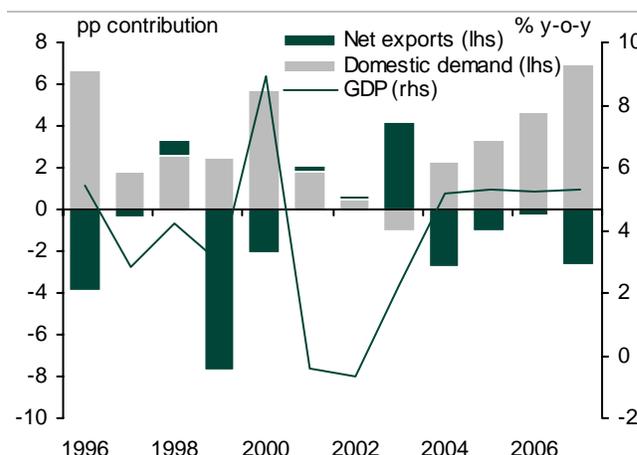
Also, the economy looks to be in a safer position from the **capital flow** perspective now,

Figure 1. Balance of payments



Source: Bank of Israel.

Figure 2. Contributions to GDP growth



Source: Central Bureau of Statistics.

...with less reliance on portfolio flows than in the past

especially compared to the 1990s. In contrast to the past decade, portfolio inflows no longer drive the capital account. In fact, quite the opposite is true: portfolio outflows have picked up significantly in the past three years as Israeli fund managers have taken advantage of the liberalisation of regulations to increase their holdings abroad.

Stable and more diversified economic growth

Although growth is likely to slow this year, to around 4%, as a result of tighter domestic monetary policy, the overall outlook is robust and not dependent on external developments. Israel has never enjoyed such **high and stable growth** rates as it has in the past four years, with annual GDP growth steadily above 5% (Figure 2). What is more – and especially significant in the current environment – growth has been driven by domestic rather than external demand, reducing Israel’s vulnerability to the global growth outlook. Although Israel’s close economic links to the US are often mentioned as the key risk for the economy and the currency, the economy is a lot more diversified now, unlike when the dotcom bubble burst in early 2000. Furthermore, given the structure of Israeli exports, the export sector is most affected by the US and European corporate fixed investment demand rather than the consumer sector and while our global economics team expects some slowing, we do not forecast a collapse.

Public finances are in excellent shape

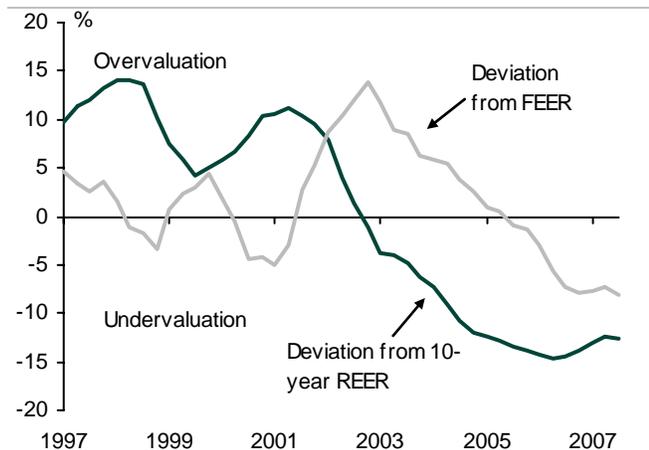
Finally, in stark contrast to most of the EMEA countries, Israel’s public finances are in excellent shape. The government’s fiscal deficit targets have been repeatedly undershot in the past few years. In fact, Israel’s budget was basically balanced last year, the best outcome for 20 years, and this year’s budget deficit target of 1.6% of GDP (already one of the lowest in EMEA) looks likely to be undershot again. The strong fiscal performance is not based only on stronger revenues but also on strict expenditure ceilings targeting a tiny 1.7% rise in real terms this year. Unlike other EMEA economies (with the exception of South Africa), Israel’s strong fiscal position gives the government room to loosen fiscal policy if necessary to offset any sharp slowdown of the economy.

UNUSUAL DIVERGENCE OF RATES AND FX

Shekel remains one of the most undervalued currencies

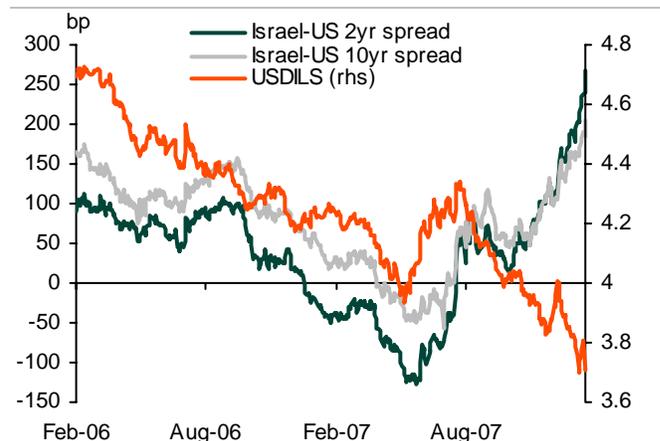
Despite the very positive fundamental story, we note that the shekel is one of the most undervalued currencies in emerging markets based on long-run real effective exchange rate basis as well as according to our macro balance FX valuation framework (Figure 3)2. And the aggressive easing by the Federal Reserve is a boon for the currency, given the sharp reversal in policy rate differentials that is taking place. Moreover, Israelis’ resolve to continue investing outside the country could be tested in the coming year, not only

Figure 3. Israel’s real exchange rate becoming more competitive



Source: BIS and Lehman Brothers.

Figure 4. Israel’s interest rate differential to the US



Source: Bloomberg.

because of the emergence of large rate differentials against core markets, but also because of underperformance by markets abroad. We would not be surprised to see Israeli investors reversing portfolio flows. Given the exceptional basic balance picture, the robust growth outlook, the level of the real exchange rate and the changing rate differentials from Fed easing, we are very comfortable with further currency strength.

If history is any guide, with currency strength should come lower local yields. But the recent divergence of interest rates from the USD/ILS exchange rate looks striking (Figure 4). For example, markets are pricing in a significant amount of policy divergence between the Bank of Israel and the Federal Reserve in the coming years. For example, the spread of two-year interest rates are at multi-year highs currently. In some sense, this is justified by the short-term outlook for inflation, which is now running above the Bank of Israel's (BoI) 1-3% inflation target range. Like elsewhere, the food and energy price shock is partly to blame, but there are also domestic factors at play. And the pass-through from the exchange rate to inflation, which used to be very high because of the dollarisation of rental contracts, has fallen. Since mid-2006, there has been a clear divergence between the housing component of the CPI and the exchange rate (Figure 5) as the share of new rental contracts denominated in dollars has fallen to about 60% from nearly 90% just over a year ago. So, the shekel's anti-inflationary impact should continue to fall.

Unusual divergence of rates and FX...

But the extent of the divergence priced in is unlikely to last, in our view. First, inflation is still looks set to fall, and quickly, in the second half of the year. After all, the pass-through from the currency to prices is still very high (even if the influence is waning). As inflation rises further in the short term, (we look for 4% in Q2) the BoI is still likely to have a tightening policy bias, especially as inflation (excluding the FX impact) is running at 4.8% y-o-y, on BoI estimates, and economic growth has remained strong. But inflation is likely to fall sharply, to 2%, by the end of the year. We expect only one more hike from the BoI to 4.5% against market expectations of around 4.75%.

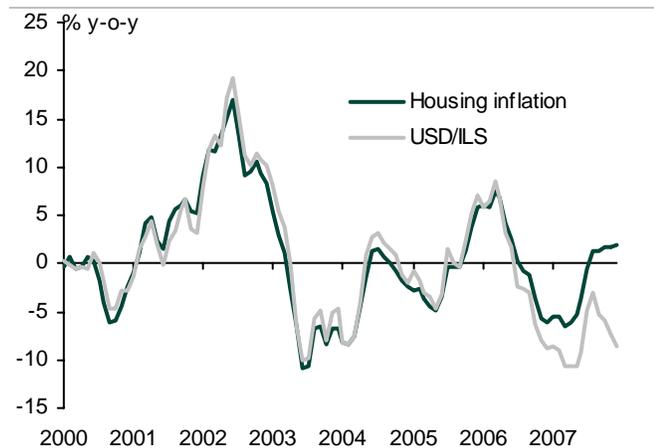
...given the positive fundamental story

Harder to justify is the extent of the spread between the US and Israel in the 10-year part of the curve, and therefore the amount of risk premium priced into Israel. It is unclear why Israel has the steepest curve in EMEA when it also has the strongest case for a secular rise in the currency, one of the best fiscal stories in the region and one of the best basic-balance pictures (Figure 6). For that very fundamental reason, we retain our long in Shahaar' 16s, the benchmark 9-year bond.

¹ Damocles: More than meets the eye, 30 November 2007.

² See FX Outlook 2008: The Return of the Macro Currency Trade for more details.

Figure 5. FX moves are becoming less important for housing rents



Source: Central Bureau of Statistics.

Figure 6. A scorecard of fundamentals

	ILS	PLN	HUF	CZK	ZAR
CA/GDP (Q3 07)	3.7	-3.9	-5.4	-3.4	-7.3
Net FDI/GDP	3.0	3.6	-0.5	3.7	-0.5
Basic balance (CA+FDI)/GDP	6.7	-0.3	-5.9	0.3	-7.8
Budget, % of GDP (2007 exp)	0.0	-2.5	-5.7	-3.2	0.5
Damocles score	0	35	31	35	26
REER vs. 10yr avg (neg=undervalued)	-11%	17%	22%	26%	0%
2yr spread over US (bp)	257	336	494	146	808
2yr real swap rate	1.7	1.9	0.0	-1.4	2.0
10yr real swap rate	2.5	1.7	-0.5	-1.0	0.8
10yr spread over US (bp)	205	179	308	49	543

Source: Lehman Brothers.

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