Israel Economic Outlook & Stock/Bond Market Review

Evan Liberman · October 19, 2014

Highlights

- Israel showing economic stability
- Israeli capital market facts and figures
- Israel: low inflation and low debt
- Low Interest Rates; money to pour into stocks
- Good time to buy shekels: exchange rate high
- Gaza War economic effects - not long lasting
- TASE lagging behind Wall Street: room for growth
- Recent drags on the market no longer at play
- Small-cap Israeli stock index interesting
- Much of economy based on Israeli innovation & creativity

The Israel economy has shown stability and maturity in the past year, weathering various economic headwinds well. Even in the recent Gaza war, the Israeli stock market lost only 1%, and has added 5% since then.

Israeli Interest Rates

Israel's interest rate had risen as high as 3.25% as recent as three years ago, and was one of the first Western nations to raise rates after the 2008-2009 global recession. But to keep up with persistent growth challenges in the U.S. and Europe - Israel's primary trading partners - the Bank of Israel decided in 2011 to begin re-lowering it's overnight lending rate. Israel again lowered its interest rate twice in the last three months to stimulate growth, to a new low of 0.25%. This is now near the 0% - 0.25% interest rate of the U.S. Federal Reserve. Israeli publicly traded industry and real estate companies are benefiting from low interest rates.

Tel Aviv Stock Exchange Facts and Figures

As of September 2014, the national stock and bond exchange in Israel had:

- 473 companies listing equities (stocks)
- 590 Exchange Traded Notes
- 32 series of government bonds
- 73 series of institutional bonds
- 614 series of corporate bonds
- 1,296 mutual funds
- Market Capitalization
  - Equities - $211 billion
  - Government bonds - $135 billion
  - Corporate bonds - $88 billion

Money Pouring into Israeli Stock Market

As interest rates in Israel continue to lower, and with real estate prices in possible bubble territory, the Israeli stock market is becoming the logical destination for investors looking for a reasonable return. The Tel Aviv 25 large-cap stock index returned almost 12% in the past 12 months (and 20.6% in 2013 in U.S. $ terms). But, in the past three years, the Tel Aviv 25 stock index has fallen behind Wall Street indices such as the S&P 500. During that period, the S&P 500 returned 54%, and the Tel Aviv 25 returned a lower, but still impressive, 32%. This was

> "Israel is the best place to invest because of its people. There is no other place with such high quality people with motivation and abilities… Israel has a very positive future."
>
> *- Warren Buffett*

due mainly to local factors, including new, heavy governmental regulations on industries such as oil/gas exploration and telecommunications, as well as Israel's new ranking as a Developed Market vs. an Emerging Market by MSCI (causing international institutional portfolio rebalancing not favoring the local Israeli market). These factors kept interest in the Israel stock market subdued for the past three years, but are now clearly past events. For decades, the Israeli stock market has far outperformed U.S. markets. Long-term investment charts show Israel outperforming Wall Street by a huge margin (in the past 12 years, S&P 500 returned 125% vs. 320% in Israel).

Israeli Innovation

Israeli innovation and creativity continues to drive new company listings on the Tel Aviv Stock Exchange. The TASE's new CEO, former CEO of the North American Derivatives Exchange in Chicago, is planning reforms that will further open the Israeli economy to foreign investors, creating new indices and ETFs for Israeli technology firms currently only traded on the TASE. This will help currently listed companies, and increase demand in Israeli stocks by foreign investors. Therefore, we believe there is room for the Israeli stock market to grow and recover its long-term outperforming status.

The stock Price-Earning (P/E) ratio is often used by investors to gauge whether a market is cheap or expensive on a historic basis. The current P/E for the Tel Aviv 25 stock index is lower than the S&P 500 P/E. This could indicate a good entry point into the Israeli stock market.

Of particular interest is the Israel small-cap index (Tel Aviv Yeter 50). It historically has outperformed the Israeli large-cap indices, but in the past year has underperformed. As we progress through the current business cycle, and investors again become more comfortable with risk, the small-cap companies will likely begin to revert to their superior performance.

Israeli Bond Market

Israel's corporate bond market has yielded approximately 6.5% annually for the past three years (actually outperforming the Israel stock market during that period). In 2013, The Tel Bond 20 index returned 13.9% in US $ terms. Year-to-date (Jan-Oct 2014) the Tel Bond 20 index has returned 4.5%, yet stocks have outperformed, so Wise Money Israel has suggested to clients a mix of Israeli stocks and bonds going forward. Wise Money Israel is cautiously optimistic about the growth potential of the Israeli stock market in the mid-term.

Gaza War Economic Effects

Operation Protective Edge (the Gaza war) launched on July 8, 2014. What was the economic influence of the operation? Israel's robust economy continued to operate normally, in spite of some inevitable damage to Israeli industry, particularly in the conflict zone (mostly the South). Financial activity (mostly in the Center) continued unabated, with all regulatory and financial institutions continuing with business as usual. Most of the damage was to tourism and industry (mostly in the South). In response, the Bank of Israel lowered the benchmark interest rate twice in the past three months by a total of 0.5%. Despite the slowdown in industrial productivity due to Army Reserve call-ups, the Tel Aviv industrial stock sector has returned over 18% since January.

The security situation in Israel naturally impacts economic activity to some degree. However, over the past few years, the Israeli economy has demonstrated exceptional resilience in the face of the challenges posed by various security-related events, and most of the country's industries succeeded in compensating for the dip in activity during these episodes.

The financial markets - the capital market and stock exchange - operated regularly, and foreign currency clearing proceeded as usual. There were some small disruptions to international flights and international mail delivery.

Despite the economic ramifications of Operation Protective Edge, leading international financial rating agency Standard & Poor's believes Israel's economy has remained stable. S&P voted confidence in Israel's economy recently when it rated it as strong, noting that Operation Protective Edge's impact on Israel's fiscal viability was minor, and expects the economy to remain stable and solid. S&P left Israel's fiscal rating at 'A+/A-1', stating that Israel's fiscal outlook is promising and firm. S&P noted Israel's production of natural gas and its relatively flexible monetary framework as contributors to Israel's economic prosperity.

Bank of Israel's Assessment: No Long-Term Impact from Short Wars

According to Israel's Central Bank, "the local and international investment community continued to show confidence in Israel's robust and resilient economy. Evidence analyzed by the Bank of Israel clearly demonstrates that brief periods of unrest have little long-term impact on Israel's macro-economic performance. The Israeli economy has illustrated its resilience and ability to recover promptly, while economic indicators do not reflect significant effects of Israeli military operations over the past decade. The Israeli economy has learned to endure and even thrive in times of crisis. Israel remains an attractive destination for international investments."

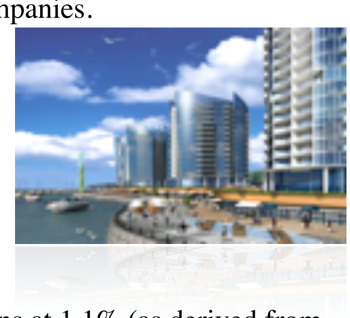
In a speech at the National Economic Conference in September, 2014, Governor of the Bank of Israel, Karnit Flug, stated, "Operation Protective Edge led to a negative economic impact felt by, among others, small business owners, exporters, and employees… Israel's economy is very influenced by global economic developments, and so, with the beginning of the European debt crisis in mid-2011, a decline in the growth rate began here as well…the decline in growth was relatively moderate; we declined to a rate of 3 percent per year, which is higher than that in most advanced economies. Likewise, despite the decline in the rate of growth, we saw in the labor market, until recently, a continued decline in the unemployment rate and increase in the employment rate—these, too, in contrast to most advanced economies… The structural deficit—that which is not dependent on one-time or cyclical shocks to the economy—is already among the greatest in the OECD…. The fact that financial markets continue to display confidence in Israel's economy, and the economy's ability to absorb the costs of the operation, are the result of responsible conduct by the government in the past two years, which contributed to the economic resilience…Israeli society displayed impressive resilience and solidarity during Operation Protective Edge."

Shekel vs. Dollar

While the Israeli currency has gained historically over the U.S. dollar (290% since 1985), in recent months the trend has been for the U.S. dollar to strength against the shekel and other world currencies. The Bank of Israel has also recently been purchasing USD to support local exporters, something the Bank doesn't do often. Until a few months ago, the Bank of Israel hadn't weakened the shekel via U.S. dollar purchases for a number of years, letting the shekel strengthen naturally against the dollar, due to Israel's strong economy. We believe that now is a good time to add dollars to your Israeli investments, as you can purchase 10% more shekels than you could have just three months ago.

Challenges to the Israeli Economy

- The cost of living in Israel remains high, and local consumer boycotts can threaten the profitability of Israel's large food manufacturers (as happened in 2011).
- Proposed new government taxes on natural resources (the Sheshinski 2 Committee) would reduce Israel Chemical Ltd.'s profits by $2 billion, hurting one of Israel's flagship industrial companies.
- Israeli real estate prices continue to be in bubble territory (The International Monetary Fund's 2013 report indicates Israeli housing prices are 25% above their equilibrium value). An average Israeli apartment costs 140 monthly salaries (comparable to a $570,000 apartment for a U.S. buyer), which is considered high globally. Despite this, the Israeli consumer is still less leveraged than the average U.S. consumer.



Inflation

Israel ranks #1 globally for inflation stability, with current 1-year inflation expectations at 1.1% (as derived from the capital market).

Employment, GDP and National Debt

Israel's unemployment rate is currently at 6.4%, with GDP estimates at 3.0% for 2015. Israel's GDP-to-Debt ratio is one of the developed world's best at only 67% (vs. 102% for the U.S.).

In summary, the Israeli capital market provides a means of investing in innovative Israeli companies both via stocks and corporate bonds while diversifying into another currency. The market is stable and resilient, and there are multiple positive factors indicating future growth potential.

Evan Liberman is the first Israeli Messianic believer to hold a license with the Israel Securities Authority. He is founder of Wise Money Israel, a registered Israeli Investment Advisory. WMI helps individuals & organizations around the globe invest in Israeli stocks, bonds & mutual funds.
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