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Israel Macro View

Trip Notes: ILS Likely To Stay An Underperformer

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- The underperformance of Israeli asset prices in recent months is a preoccupation of local observers, who generally argue that this underperformance is not primarily due to geopolitical risks, but rather to local economic factors, notably: i) the collapse in export growth and consequent fall in the current account surplus; and ii) the decline in consumer confidence.

- It follows from this that any increase in geopolitical risk could do a lot of further damage to the ILS. But based on the conversations we had, we lean towards the view that any potential Israeli strike against Iran's nuclear facilities would more likely be *later* than sooner: i.e. towards the end of 2012 if at all this year. The Prime Minister is generally characterised as cautious, consensus-seeking, risk-averse and eager to win the support of the US for any military action. In addition, Israel may feel obliged to see international sanctions against Iran fail before considering any military attack.

- Economic risks don't point decisively one way or another. One the one hand there are plenty of indications that Israeli GDP growth will be sub-3% this year, from 4.8% the previous 2 years: i) credit markets are weak; ii) we detected no optimism about the prospects for house prices 2012, which will feed through via wealth effects; iii) the sharp rise in investment spending last year is unlikely to be repeated; and iv) exports and PMIs still point to slowdown. On the other hand, the labour market seems tight, and tax revenues are buoyant, indicating that the slowdown should not be too severe.

- Inflation expectations have risen recently, and could rise further given the impact of higher fuel and electricity prices. This could shift up the market's expectation of a rate hike in the near term, but we think the *actual* prospect of a rate hike is by no means clear. While we doubt that the BOI will ease policy any further, we suspect that the BOI will remain focused on downside risks to economic activity in 2012, given Israel's sensitivity to weak global demand. If higher oil prices become a threat, for example, we think the Monetary Policy Committee will worry more about its negative impact on global demand than its positive impact on Israeli CPI. On balance, we think the BOI is likely to welcome further ILS depreciation. Overall, we remain comfortable with our view that ILS will be weaken further, but now think that rates will be on hold for the foreseeable future.

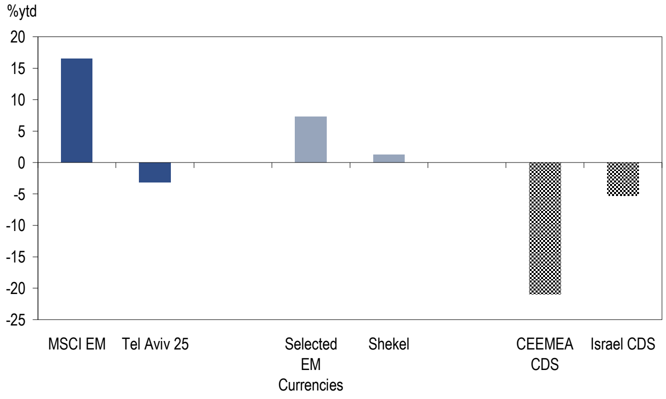
See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Israel Trip Notes

These notes are based on meetings in Tel Aviv and Jerusalem on 28-29 February with officials from the Finance Ministry, the National Economic Council, the Bank of Israel and the Monetary Policy Committee, as well as with private sector economists and other analysts.

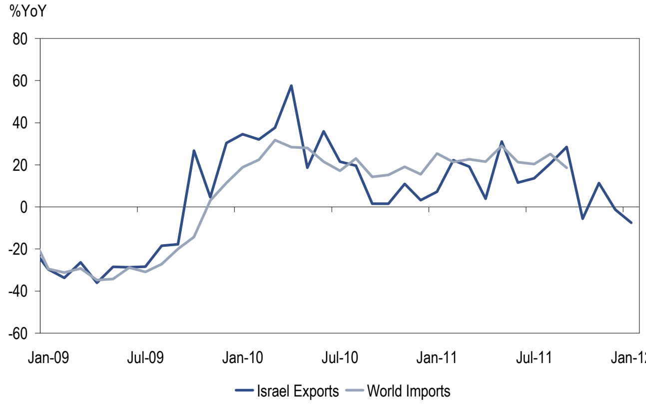
Much attention is being focused on the recent underperformance of Israeli assets. The nature of this underperformance is evident from Figure 1, and it is worth highlighting that those we spoke to don't see geopolitical risk as being the primary driver of this weakness. For local observers, the weakness of Israeli asset prices is mostly explained by i) the 2011 deterioration in the current account balance and Israel's sensitivity to weak global demand (Figure 2); ii) the decline in consumer confidence and softness of the housing market; and iii) expected changes to the structure of the corporate sector – a breaking-up of some large conglomerates – that follow from last summer's social protests. Some locals feel it is primarily these factors that help explain an important change in the behaviour of Israeli residents last year, namely that they bought foreign assets on a currency-unhedged basis. Although Israelis had bought foreign assets in previous years, currency hedges had been put in place in those years.

Figure 1. YTD performance of Israeli assets seems weak in comparison to EM, but views differ about how much this has to do with geopolitics.



Source: Bloomberg; Citi Investment Research and Analysis. EM currencies included: BRL, MXN, CLP, TRY, ZAR, PLN, HUF, IDR, KRW, PHP, THB)

Figure 2. Israel's sensitivity to weak world demand growth is a persistent theme with those we spoke to.



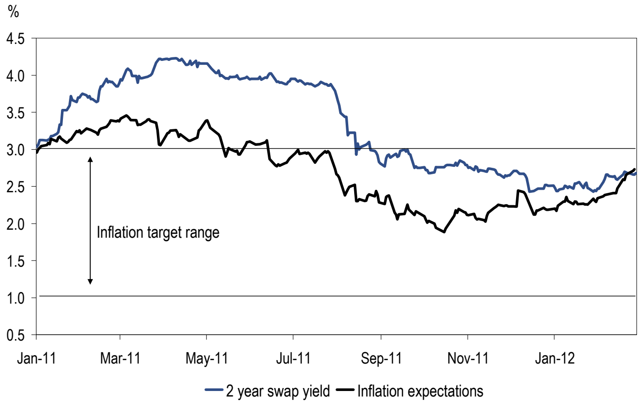
Source: Haver; Citi Investment Research and Analysis

The Bank of Israel (BOI) seems satisfied with the depreciation of the shekel as a tool to absorb the shock of weak external demand. Although ILS *ap*preciation might be expected if the bank ends up having to raise interest rates in 2012, it is by no means clear to us that a rate hike is on the cards this year, in spite of the recent risk in inflation expectations (Figure 3). Inflation expectations have risen partly due to seasonal factors – January usually sees a decline in CPI – and partly due to some cost-push factors. Of these, the strongest seem to be the rise in oil prices and the prospect of rising electricity prices. But inflation expectations are still 50bp below the ceiling of the BOI's 1-3% target range, and we didn't speak to any observers who expected a further large spike in inflation expectations – although there are some risks in that direction. This seems due to the fact that a number of forces are likely to keep demand conditions weak during 2012, including:

- Weak credit markets, as banks adjust to new capital requirements that are expected to be announced at the end of March; and as corporates face tighter requirements for domestic bond issuance;

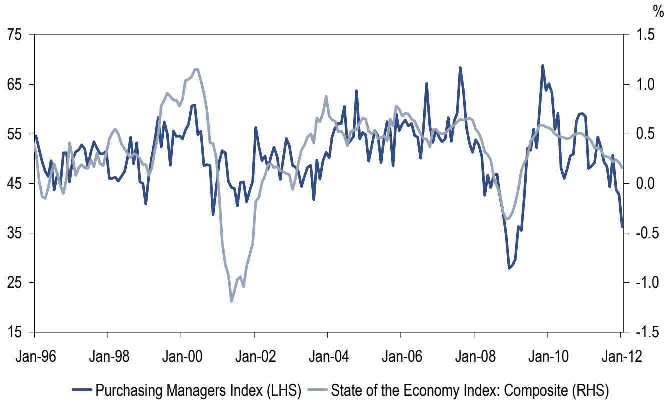
- The impact of falling house prices on consumer confidence and spending. Measured house prices fell 1.3% in Q4, and although prices rose in January, we did not detect much optimism about the future of house prices in 2012. Speculative demand for property seems particularly weak;
- The exceptional weakness of the PMI and other indicators of activity (Figure 4);
- The expectation that investment spending growth is likely to slow down this year after a strong 2011 (which was itself partly related to the strength of the housing market, which now seems much more subdued).

Figure 3. 2-year swap yields have shifted up as investors recognise that rising inflation expectations reduce the chances of another rate cut…



Source: Haver; Citi Investment Research and Analysis

Figure 4. …but the deceleration in activity is likely to make the BOI cautious about raising rates we think



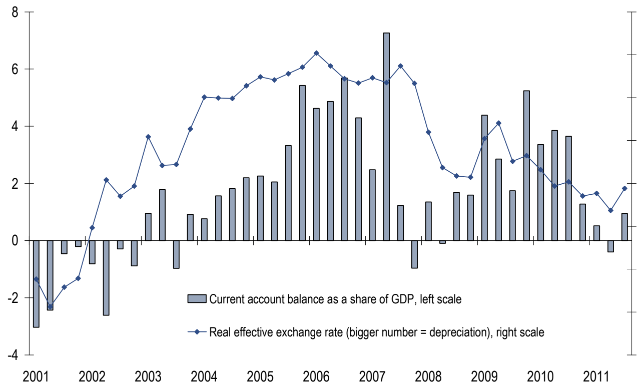
Source: Haver; Citi Investment Research and Analysis

Yet the overall story about Israeli economic activity does seem mixed. The bullet-points above have to be stacked against other pieces of evidence that point to a stronger macro story. In the first place, tax revenues seem to be running at a stronger rate than is consistent with very weak domestic demand. Tax revenues rose by almost 5% YoY in Q4, somewhat higher than the previous two quarters, and this has led a number of observers to expect heavy revisions in the preliminary Q4 national accounts data, which point to 4% annualised decline in private consumer spending. A second factor pointing to relatively buoyant growth is the labour market. The unemployment rate fell to 5.4% at the end of last year, an all-time low, and some express the view that Israel is now in a state of full employment. That said, wage pressures are not building up, probably thanks to the effect of globalisation and the arrival of new entrants to the labour market.

On balance, our view is that Israel seems set for a GDP growth rate of below 3% in 2012 – in contrast to the 4.8% growth seen in both 2011 and 2010 – but that the chances of a further rate cut have disappeared. (We had previously expected a further 25bp cut in the Bank's repo rate to 2.25%). All this said, the case for a rate *hike* in 2012 is far from clear. If higher oil prices become a threat, for example, we think the Monetary Policy Committee will worry more about its negative impact on global demand than its positive impact on Israeli CPI. A consistent theme of our discussions was the level of concern expressed about the threat to Israeli exports if global demand weakens. Overall, the chances of a rate hike in 2012 are non-zero, but not our central scenario. The market's *expectations* of a rate hike, however, may well rise if oil and electricity prices deliver some CPI shocks in the next few months.

Public finances are weaker than planned, but financing risks seem very low. There is a broad consensus that this year's budget deficit will be closer to 3.4% GDP than the 2% contained in the 2011-12 budget. The overshoot should result partly from weak growth, and partly from unfunded spending commitments that result from the Trajtenberg Commission, a body set up in the wake of last year's protest movement to recommend policy responses to the protesters' demands. The Trajtenberg Commission's starting point was that its recommendations would be consistent with Israel's fiscal rule, and indeed some of its recommendations – suspending some tax cuts that had been planned, for example, and increases in both corporate income tax and capital gains tax – are revenue-enhancing. Yet the IMF and the Bank of Israel have suggested that some spending commitments – on teachers' wages, childcare and tax-breaks for families – will not be achievable without breaking the rule. A bigger concern is the 2013 deficit target of 1.5%, which the government acknowledges will be very difficult to achieve without a sharp rise in growth.

Figure 5. Israel's real exchange rate no longer looks cheap enough to support large current account surpluses…



Source: Haver; Citi Investment Research and Analysis

Figure 6. …but the projected income from Israel's gas production should be of high macroeconomic significance later this decade

Source: National Economic Council; Citi Investment Research and Analysis

The finance ministry has a lot of financing flexibility this year. The government's gross financing requirement this year is close to ILS100bn, of which the deficit will make up around ILS30 bn. Finding buyers for debt hasn't yet been a problem: ILS15 bn of issuance was achieved in January, and since only 6.5% of the Shahar (ILS-denominated bonds) are owned by foreigners, Israel is relatively insulated from 'risk off' sentiment by foreign bondholders. Moreover, the government currently has a large cash cushion – some ILS25bn – and can also rely on two sources of 'emergency' finance: i) 'State of Israel bonds' issued to the Jewish diaspora (normally worth around $1bn per year, but higher at times of crisis); and ii) the US loan guarantees programme, under which Israel could issue US-treasury-guaranteed debt (although as things stand this programme will expire at the end of 2012).

The longer-term outlook for Israeli public finances is substantially improved by the country's future as a gas producer. The government has recently announced that it will create a Sovereign Wealth Fund (SWF) to house excess profit taxes that it will receive from gas production due to start in the second half of the decade. The government estimates the PV of government revenues from gas at $35 billion, or some 15% GDP. Stacked against a current public debt stock of some 75% GDP, the impact of the 2010 gas discoveries is highly significant from a macro point of view. Based on an estimate that gas reserves will reach 40 trillion cubic feet (from the current 23 tcf), the government reckons that the SWF will reach (in current dollars) some $83bn in 2040, or 8.7% of projected GDP.

Under normal circumstances, the prospect of a substantially enhanced sovereign balance sheet could be expected to constrain depreciation pressures on the shekel – were it not for unquantifiable geopolitical risk.

There is a range of views locally about Israel's geopolitical risk. Based on the conversations we had, we lean towards the view that any potential Israeli strike against Iran's nuclear facilities would more likely be later than sooner, i.e. towards the end of 2012 if at all this year. Although it may well be true that PM Netanyahu wants to confront the 'existential threat' posed by a nuclear-weapons-capable Iran, our conversations generated three reasons for thinking that any attack would be likely to be delayed:

- First, the PM is generally characterised as cautious, consensus-seeking, risk-averse and eager to win the support of the US for any military action. Indeed, Netanyahu has recently been criticised for allegedly pushing US legislators to put pressure on President Obama to adopt a more Israel-friendly stance on the question of a strike against Iran.
- Second, Israel has been an exceptionally outspoken proponent of tightening sanctions on Iran, and since the EU and the US have recently moved in this direction, there may be an obligation on Israel to see sanctions fail before implementing any plans it may have for a military strike against Iran. Since the EU's oil sanctions only come fully into force in July, this would argue against any immediate potential military action.
- Third, a number of recently-retired Israeli defence officials have argued publicly against a military strike, suggesting there maybe increased opposition to this within the defence establishment.

A further complication is Israel's electoral timetable. Elections aren't technically due until October 2013, but there is widespread discussion about a possible early election later in 2012. Netanyahu's party, Likud, enjoys strong support in recent opinion polls that suggest that he could increase its number of Knesset seats from the current 27 to 39 by calling an election soon. An early election might also help the Prime Minister deal with some uncomfortable issues in the near term, such as the role of ultra-orthodox Jews in the military, and the 2013-14 budget, which would likely require some heavy adjustments in order to conform with the 1.5% deficit target. And an election might become unavoidable if fraud charges are brought against Avigdor Lieberman, leader of the Yisrael Beiteinu party that is Likud's main coalition partner. All in all Israel's electoral timetable might be another reason to expect any potential military strikes on Iran to occur later rather than sooner.

Overall, our meetings have reaffirmed our view about risks to the ILS; but we are much less confident that the policy rate will be cut again this year. Israel no longer benefits from the 'subsidy' of an undervalued exchange rate, as it did for much of the 2000s (Figure 5). The fact that Israel's real exchange rate is no longer so depreciated will likely keep the Bank of Israel sensitive to the risk of external demand shock, and therefore relaxed about exchange rate depreciation. It follows from this that the risk of BOI intervention to contain any ILS depreciation is quite low. As a result, we continue to see risks of ILS underperformance in the near term. This could change if rates rise in Israel. While we think the market is more likely to expect a rise in interest rates near term, it is less likely that the BOI will actually deliver a rate hike in 2012.

Appendix A-1

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