

# GLOBAL VIEW



## Economic Review

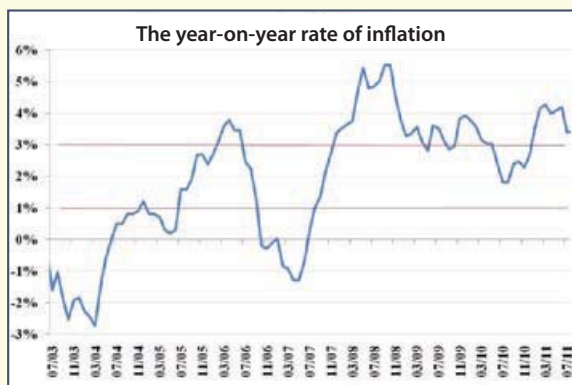
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Israel

**The consumer price index increased 0.5% m/m in August, while inflation over the trailing 12-month period stands at 3.4%**

The consumer price index (CPI) for August increased 0.5%, with the following components making notable contributions to the increase: owned housing services; recreation, holidays, and trips in Israel and abroad; and, electricity for home consumption, which increased in accordance to the tariffs update published in August. In contrast, a decline occurred in the seasonal components and also in the food component, which has shown moderation in the last three indices. Since the start of the year the increase in the CPI has amounted to 2.4%. As can be seen in the accompanying diagram, inflation over the trailing 12-month period stands at 3.4%, which is slightly above the price stability target range of 1-3%.



Looking forward, we estimate the moderation in inflation will continue, as the index ultimately enters to within the price stability target range. This moderation is expected to come against the backdrop of a slowdown in local demand, which is evident in various economic indices, such as the index of credit card purchases, indices on

the proceeds of marketing chains and of the trade and services sectors, and also in the import indices. In addition, the impact of the wave of public complaints and demonstrations calling for a cut in prices is already noticeable now, especially in food prices, and this is likely to be reflected in upcoming indices.

Regarding the owned housing services component, the contribution of which to the rise in inflation is the most significant, we estimate the increase in prices is expected to continue, although to moderate slightly, due to seasonal effects (the last quarter of the year is characterized by a decline in demand compared to the summer months). We are reminded that the owned housing services component within the CPI is calculated on the basis of the changes in rental prices of renewed contracts, and in light of the decline in the number of residential home purchase transactions, it is reasonable that there is a shift of demand from the home purchase market to the housing rental market. This trend supports a continuation in the rise in prices in this component as mentioned above. However, we add that during the last three years, it can be assumed, that the supply of rental housing has increased, due to the massive entrance of investors into the market, and this will have the impact of slightly moderating the impact of the rise in demand.

Regarding the monetary policy of the Bank of Israel (BoI), we estimate at this stage that the BoI will keep its interest rate at the current level for an extended period, as the expected moderation in inflation, which is already evident,



will cause an increase in the expected real rate (the interest rate of the Bol minus the capital market derived inflation expectations) to above 1%. This compares to a negative real interest rate of close to 2% that was prevalent two years ago.

From the wording used in the last interest rate announcement of the Bol it can be learned that a cut in the interest rate is possible. Such a cut would likely occur against the backdrop of a deterioration in the international and local underlying economic conditions. The data presented above show the Bol has at its disposal a large spread for lowering the interest rate, in the event there will be a need for it. This is in contrast to the situation existing in Europe and the US for example.

#### Foreign trade by country

Foreign trade data for the first eight months of the year show there are 19 countries that make up the main destinations for Israeli exports (excluding diamonds). The proportion of each country is at least 1.5%, and all together they receive 77% of all of Israel's exports excluding diamonds.

At the top of the list of Israel's trading partners is the US, which receives 26% of Israel's exports excluding diamonds. The second largest export destination is China, whose proportion is trending upwards. Turkey, which recently has been experiencing some political tension with Israel that could impact also on economic aspects, is the sixth highest destination for Israeli export (its proportion in 2011, 4%, of total Israeli export, excluding diamonds).

Among Israel's main export destinations there are some countries still suffering from crisis, such as the large EU countries, and also countries that were only slightly hurt by the global crisis. Alongside factors that negatively impact the export sectors, such as the notable slowdown in economic activity of the US and the EU countries, there are also central destinations of Israeli exports that have relatively positive economic situations, and this has the impact of moderating the weakness in exports. To this we add that within Israeli exports there are "niche products" in which Israel enjoys a comparative advantage, and this also has the effect of moderating the weakness in exports.

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By: Sagit Cohen, Economics Sector, Leumi Israel



Euro Zone

#### Soft Patch or Double Dip?

As we enter the final quarter of 2011 the more pessimistic among us seem to be questioning whether the current, undeniable, slowdown could actually be the early signs of a double dip recession. Gold has, once again, hit new all time highs of over \$1900 in early September before plummeting back to around \$1600 and general market consensus seems to be becoming more risk averse by the day. The United States provides a fair barometer for a number of the major economies and unfortunately macroeconomic data has proved prolonged weakness. Gross Domestic Product, Consumer Spending, Services & Manufacturing Indices and the Stock market are all going through a torrid time. If the old saying is true that 'when the United States sneezes the rest of the world catches a cold' then it looks like it's time for flu vaccinations!

Greece has remained the dominant story, and particularly since the summer, with continuing credit downgrades during the course of this year. Greece's credit rate revisions have been followed by additional downgrades of Italy in September; unfortunately the market expectation seems to be that we've not seen the last of the sovereign rating downgrades. Spain, Portugal, Cyprus and, some might argue, Ireland remain among the additional potential downgrade candidates, but the lack of any strong political will in Europe is continuing to cast a dark cloud over any signs of recovery.

Perhaps it will come as no surprise that the Bank of China has stopped trading FX swaps and forwards with several European banks. The market remains unimpressed with the lack of detail emerging from the recent European Union and International Monetary Fund's conferences. To add insult to injury there is currently some discussion around the fact that the Greek Prime Minister is considering a referendum on whether his country should remain in the Eurozone or not. No doubt we have not heard the end of the Greek saga but there certainly seems to be a feeling in the market that the situation for the Eurozone can only get worse before it gets better.

According to World Bank Chief Robert Zoellick, the world economy is "in a danger zone" and IMF boss Christine Lagarde reiterated recently that the path to recovery is narrowing. German, French, Spanish and Italian credit

default swaps all hit new all time highs towards the end of September as market gloom deepened and concern over the ability of Eurozone governments to pay their debts intensified.

During such a time of high volatility there is one thing that seems more assured; base rates for the major economies do not appear to be going anywhere for the foreseeable future. Given that the UK, US and Eurozone are all now indicating that there will be no change in stance until 2012 or even 2013 the market turns once again to discussions on Quantitative Easing.

Without meaning to encourage the scaremongers, markets are currently looking very similar to this time three years ago. We have a stronger USD, weaker equities, weaker commodities, weaker emerging market currencies and higher bonds with massive inversion in the curve in Europe. The UK Chancellor, George Osborne, is quoted in the UK press as saying there are less than six weeks to save the Euro and I'm sure that none of us need reminding that it was around September and October of 2008 when fear started to turn to panic before policy makers responded. One hopes that there is enough foresight this time around to try to prevent such panic. With the market volatility and excitable events of the last six months it is hard to even begin to imagine the extent of what is going to happen next!

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By: Sarah Card, Corporate Dealer; Bank Leumi UK



### The United States

#### Failure to Launch

The picture in my head is from one of those news reels of a failed rocket launch. You know the ones where a huge rocket stands on the launch pad, fully fueled, countdown 3, 2, 1, ignition, rises several hundred feet, looks like all is a "go" and then they

just can't follow through. At that point, gravity pulls the rocket back to earth in a cataclysmic crash and burn.

The above is a little extreme but it does remind me of what the U.S. and global economies might be going through. I say this because two years after the financial crisis and great recession, after TARP, fiscal stimulus I and II, rate cuts to zero, QE I and II; after all of this effort the U.S economy did show signs of lift-off in 2010. However, in 2011 the recovery seems to have succumbed to the pull of gravity with velocity being lost. The S&P downgrade of the U.S. credit seems to have crystallized how the aftermath of the financial crisis and continued Washington gridlock have weakened U.S. prospects. But as bad as it appears in the U.S.; Europe is even more entangled as it grapples with a spreading sovereign debt crisis. And it could be that the larger economies of Italy and Spain may be falling into recession where the smaller economies of Greece and Portugal already reside.

As each continent looks to others for signs of hope; there seems little help to be found as Emerging Markets and even China have lost their sizzle. In the U.S., after growing 3.1% in 2010, GDP has grown just 0.85% at an annual rate in the 1st half of 2011. This deceleration was highlighted in August by a zero jobs report; the weakest since September 2010 with an unemployment rate that remains above 9.0%. Job growth averaged almost 180,000 per month in the first 4 months of this year but has since collapsed to an anemic 40,000 over the last four months. Growth over the next four quarters will struggle to average much above 1.5%.

#### Twist and Shout

In another attempt to avoid the dreaded crash and burn, both the Administration and the Central Bank took further action. President Obama proposed a new \$450 billion American Jobs Act (call it fiscal stimulus III) in early September. The plan was presented to the nation in a televised prime-time presentation. Over subsequent

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days the plan was promoted by the President in a several state tour wherein he "shouted" about the virtues of this round of stimulus and exhorted Congress to "pass this bill now!" The President stressed that the bill will keep teachers working, create infrastructure construction jobs, give incentives to businesses that hire the long term unemployed, extend long term unemployment insurance, provide training for the structurally unemployed and expand the payroll tax cut that was initially enacted in 2011. But although the President says the bill will be paid for as part of his long-term deficit reduction plan, many Republicans don't believe it and they will have a hard time approving the full package as presented.

The Fed also took action by reviving a half century old plan known as "operation twist", a strategy intended to push borrowing rates, especially for mortgages, even lower. The plan will have the Fed selling \$400 billion of short term (3 months to 3 year) Treasury securities from its portfolio and use the proceeds to buy \$400 billion of longer-term bonds (5 years and longer) by mid-2012. The announcement did push long term rates significantly lower but short term Treasury rates did not rise appreciably in the face of the Fed's \$400 billion planed sale. Why not? Because the Fed was clever enough to announce to the world, in August, that it intended to keep the Fed Funds rate at virtually zero until at least the middle of 2013. Thus, any rise in short term rates should not be significant. But it remains to be seen if pushing mortgage rates even lower than they already are will have much effect on a housing market that remains virtually in depression with too much supply and very little demand.

### Volatility All Around

Global anxieties over the faltering of many economies, the stress of trying to deal with the European sovereign debt crisis, the Fed's pledge to keep rates low through mid-2013 and operation twist all combined to push interest rates to record lows. Two-year Treasury rates fell to a record low of 0.14% on September 20 compared to the recent high of 0.90% in April. Ten-year rates plunged to a record low of 1.67% recently compared to this year's high of 3.77% in February. Thirty year yields fell sharply (though not to a record) to 2.74% from 4.79% in February. The decline in 10 and 30 year rates will make mortgage rates even more attractive but I would expect only a limited response as consumers have not

exhibited solid confidence in the economy or job prospects. Looking ahead it seems that rates will remain at these depressed levels for the foreseeable future.

The USD was bid up strongly over the past several months as the risk-off mentality boosted the appeal of the greenback and it should continue to gain strength. Unfortunately, the stronger USD will be a negative for U.S. equities as it will cut into exports. The EUR was especially weak, losing 10% of its value to 1.34 from 1.49 in May. At times there was growing anxiety that certain weak members might be thrown out of the EUR while at other times there was fear that Germany itself might withdraw from the currency union. Looking ahead, the EUR should remain under pressure as Europe struggles to address its finances, but a collapse is not anticipated. The JPY remained stable for the most part and should remain so as it continues to be viewed as a diversification currency away from the turmoil in both the U.S. and Europe.

Equities struggled over the summer months as global and U.S. growth faltered. Volatility, as measured by the VIX spiked to almost 50 in August from 14 in April as it is now common for equity indices to move by several percentage points each day. The DOW Jones 30 fell 17.5% from its 2011 high of 12,876 in May to a low of 10,597 recently. For the year the DOW closed the 3rd Qtr. down 5.7%. The S&P 500 performed even worse, falling 19.6% from the yearly high of 1,371 to as low as 1,101 on August 9. For the year, the S&P is down 10%. Volatility should remain high in the period ahead and I think equity values could move 5.0% lower before finding a bottom.

By: Bob Giordano, Treasury Management,  
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### Select Indices – 1 October 2011

Index	Value	% Return YTD in 2011
S&P 500	1124	-10.5
MSCI World	1074	-16.0
Global Broad Corp.	223.15	3.5
High Yield Global Bond	775.67	-1.05
CRB Total Commodity	293.3	-12.0

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