WEEKLY CAPITAL MARKET REVIEW

March 18, 2018

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Our main investment recommendations

- The global economy keeps improving against a backdrop of slowly rising inflation. The longer this trend continues, the greater the likelihood of it spawning the gradual transition away from the ultraloose monetary policies of recent years. And rising rates, it's worth noting, could lead to changes over time in the way all assets classes are priced.

- Israel's economy also shows signs of ongoing improvement against a backdrop of low inflation and a strong shekel relative to its 2-year average—factors that should enable the Bank of Israel to keep its policy rate at near-zero levels for the time being. But the degree of uncertainty in the local market has risen over the past few weeks, and recent data indicate a modest slowdown in the housing sector relative to the past two years.

- We expect inflation in Israel to rise at a more subdued pace than in overseas economies, thanks to further measures by the government to bring down the cost of living, slower rises in housing prices (as reflected in the consumer price index), and the strong shekel. But a faster pace of wage growth, as well as solid demand, and the slow rise in inflation in overseas economies, could mitigate the impact of the aforementioned factors.

- We recommend positioning bond portfolios in short to intermediate durations, given that interest rates are projected to rise across the globe in coming years. We also advise maintaining a slightly longer duration in Israeli fixed-rate sovereign bonds than in equivalent bonds overseas, based on our assessment that the Bank of Israel is likely to leave its policy rate unchanged for an extended period, while monetary policy in some of the world's leading economies may prove less accommodative in the months ahead.

- As to corporate bonds in Israel and abroad, we recommend high rather than low rated issues, given the narrow spreads available on the latter.

- We continue recommending that investors maintain an average level of equities in their portfolios, and that shares serve as the primary means of gaining exposure to risk assets. While it’s true that equity valuations are high by historical standards, so are the valuations of all other asset classes.

- Investors are advised to be selective in their choice of stocks, avoiding general index-linked products, both in Israel and abroad. Moreover, certain sectors (and parts of the world) are likely to benefit more than others from the global economy’s continued growth—particularly industries with a lower sensitivity to rising interest rates.

- The gap between the Federal Reserve’s benchmark interest rate and that of the Bank of Israel is expected to continue growing in 2018. The widening gap in the two countries’ policy rates should somewhat decrease the underlying pressures for the shekel’s appreciation. We advise that investors gain significant exposure to foreign currencies by investing in overseas stocks and corporate bonds—a recommendation based, in part, on the potential for forex holdings to reduce the overall volatility of investment portfolios. Investors should choose a suitable degree of forex holdings and put currency hedges in place if necessary, in order to avoid overexposing their portfolios to currency risks.

- It’s critical that investors find the right balance between risk assets, on the one hand (shares, commodities, and corporate bonds), and highly liquid assets and government bonds, on the other. The aim is to create a safety cushion that maintains portfolio risks at reasonable levels.

Market developments

Market volatility persists. Most major equity indices declined last week, following the previous week’s sharp gains. While most leading economies remain on a solid footing, a slight slowdown in economic activity is now evident in certain countries.

In the US, industrial production in February rose by 1.1%, beating consensus figures. The number of job vacancies in January came in better than expected, at 6.3 million—its highest level in more than a decade. In contrast, February housing starts declined more sharply than expected, as did retail sales. It’s possible that some of this slowdown is attributable, in certain sectors, to increased financing costs in recent months for both households and companies, driven by the Fed’s rate hikes and the jump in US Treasury yields. In the eurozone, industrial production in January came in lower than expected, falling 1% from the previous month. Moreover, inflation was up less than expected, rising at an annualized 1.1% pace from a year ago, marking a slower rise in consumer prices.

A slowing in global trade remained a central investor focus last week, after the US government scotched the sale of US-based Qualcomm to Singapore-based Broadcom, in addition to remarks made by Pres. Trump, who wants to see a $60 billion reduction in the US trade deficit with China.

In Israel, major stock indices notched up fairly sizable gains, bucking the global trend. Leading the way up was the banking sector, as the TA Bank index gained 3.5%, lifted by the sector's strong quarterly results. Government bonds fluctuated modestly. At the end of the week, the Central Bureau of Statistics released its inflation update for February (see below), which included a continued decline in housing prices—a development with the potential to affect other sectors of the economy going forward.

Bond markets

- Bond yields slipped in major overseas markets, particularly at the long end of the curve, against the backdrop of mixed US economic data, a decline in the inflation expectations priced into the market, and investor concerns that global trade may be about to come under pressure.

- America's consumer price index for February rose 0.2%, in line with projections, and is now up 2.2% on a 12-month trailing basis. The inflation expectations reflected in bond prices slipped a touch, owing in part to a slower-than-expected increase in average wages in February.

- Ten-year Treasury yields edged down against the backdrop of the aforementioned decline in inflation expectations. But short-dated Treasury yields were up 3 basis points on the week, reaching their highest level in a decade. In the corporate bond market, spreads widened marginally on both investment- and non-investment-grade bonds, extending the trend of recent weeks. The Federal Reserve is set to make its interest-rate announcement this week, and fed-funds futures continue indicating total certainty that the central bank will hike its policy rate at this week's meeting of the FOMC. Investors will focus on the Fed's economic forecast accompanying the interest-rate announcement, particularly regarding the future direction of rates.

- The eurozone's CPI for February was in line with analyst forecasts, but on a 12-month trailing basis inflation was a bit lower than expected, with the annual pace slipping to 1.1%. In consequence, German bund yields fell by 4 to 8 basis points across the curve.

- Israel's CPI for February came in at a higher-than-expected 0.1%, and the annual rate edged up to 0.2%. The fastest rising components in the CPI report included a 9.4% jump in fresh vegetable prices and a 0.8% rise in the cost of transportation. February's report was a bit higher than expected, despite the unexpected slower price rise of lease renewals on apartments, to an annualized increase of 1.9%. Yields on fixed-rate and CPI-linked government bonds fluctuated modestly. In the corporate bond market, most Tel Bond indices posted solid gains, while credit spreads narrowed. But the Tel Bond Global index pulled back slightly, extending its underperformance.

Stock markets

- Stocks fell across the globe last week, amidst persistent volatility. Strong numbers out of the US jobs market and favorable geopolitical developments between the US and North Korea helped lift stocks at the beginning of the week. But then the trend shifted, primarily driven by concerns that global trade may come under pressure due to US administration initiatives to reduce America's trade deficit. The aborted merger plan between chipmakers Broadcom and Qualcomm also caught investors' attention. Near the end of the week, economic data releases included a rise in industrial production and an increase in the number of job vacancies. In response, the Dow Jones Industrial Average and S&P 500 staged a slight upward correction.

- Israeli shares were up on the week, with the local market outperforming its overseas counterparts. The rally was led by bank shares, which continued benefiting from lenders' solid quarterly earnings reports, which included low loan-loss provisions. Positive sentiment towards the energy sector continued, driven by news about the possible signing of a large gas export deal by the consortium that owns the Leviathan field. Investors remained focused on the flow of corporate earnings releases. Some stocks in the information technology and service sectors rallied sharply, following the release of robust reports. In contrast, some firms in the food sector saw sharp share-price falls in the wake of disappointing earnings releases. Communications shares continued selling off, in part due to investor fears over intensifying competition in the TV and mobile segments.

Forex & commodities

- The dollar kept inching up against most of its major rivals, marking a fourth straight week of gains. Amongst the biggest decliners against the greenback were the Canadian and Australian dollars, which fell 2.2% and 1.7%, respectively, following their strong gains the prior week. In contrast, the Norwegian krone and Japanese yen each rose 0.8% against the buck. The shekel was little changed against the dollar, and by the end of the week was trading at NIS 3.45.

- In the commodities market, the price of WTI crude was up 0.5% last week, while most other commodities fell, including precious and industrial metals and agricultural commodities. Gold slid 0.7%, after having risen in recent months, driven by the rise in global inflation expectations.

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Local and overseas stock markets

Inflation expectations as derived from the govt. bond market

	Current	A week ago	A month ago
1 yr ahead*	0.60%	0.60%	0.50%
3 yrs ahead	1.10%	1.10%	1.05%
10 yrs ahead	1.58%	1.59%	1.62%

*Based on the OTC market

Major corporate bond indices

	Weekly % change	Ave. yield	Spread
Tel Bond 20	0.64%	0.89%	1.24%
Tel Bond 40	0.48%	0.70%	1.26%
Tel Bond Fixed-Rate	0.46%	2.48%	1.72%
Tel Bond CPI-Linked Yeter	0.22%	0.88%	1.36%
Tel Bond CPI-Linked Banks	0.22%	0.06%	0.73%
Tel Bond Yields	0.74%	1.86%	2.36%

Corporate yield spreads over govt CPI-linked bonds by credit rating

Duration in yrs	AA- to AAA	A- to A+	BBB- to +BBB
0-3	0.73%	1.58%	2.51%
3-6	1.02%	1.73%	3.09%
6-10	1.29%	1.90%	-

Major overseas bond markets

	US Treasuries		German bunds	
	Yield		Yield	
Maturity	Current	Week ago	Current	Week ago
2	2.29%	2.26%	-0.59%	-0.56%
5	2.64%	2.65%	-0.04%	0.03%
10	2.84%	2.89%	0.57%	0.65%

Government bond indices by linkage-type and duration

	Weekly % change	Ave. yield
CPI-linked (0-2yr)	0.0%	-
Govt CPI-linked (2-5yr)	-0.1%	-0.6%
Govt CPI-linked (5-10yr)	-0.1%	-0.1%
Govt fixed-rate (0-2yr)	0.0%	0.2%
Govt fixed-rate (2-5yr)	0.1%	0.6%
Govt fixed-rate (5yr+)	0.2%	1.7%
Govt floating-rate	0.0%	0.2%

Stock-market returns

ISRAEL		
Index	YTD returns	This week's returns
TA-35	-0.3%	1.6%
TA-90	0.5%	2.0%
Bank Index	3.5%	3.5%
Tel Aviv Real Estate	-4.1%	1.2%
SME 60	-0.3%	2.0%
TA Comm.	-7.9%	1.6%
TA Tech.	0.3%	2.2%
TA Oil & Gas	10.5%	4.0%

GLOBAL		
Index	YTD returns	This week's returns
S&P500	2.9%	-1.2%
Nasdaq Composite	8.4%	-1.0%
Stoxx Europe 600	-2.9%	-0.1%
Germany	-4.1%	0.3%
France	-0.6%	0.2%
U.K.	-6.8%	-0.8%
China	-1.1%	-1.1%
Japan	-4.8%	1.0%

Updated to the close of Thursday's trading in Tel Aviv

Exchange rates

	YTD change	This week's change
Dollar / Shekel	-0.4%	0.0%
Euro / Shekel	2.4%	0.0%