

Monthly Macroeconomic Review

November 2, 2009

- **Current indicators of economic activity** painted a mixed picture over the last month. In September, imports and exports of goods declined, and tax revenues were slightly below the trajectory of the preceding months. By contrast, the number of incoming tourists increased. In August, the industrial production index and the trade and service sectors revenue index rose sharply. In our opinion, based on the economic indicators published so far, **accelerated growth is emerging for the third quarter**, as compared to the previous quarter.
- **Israel's Central Bureau of Statistics** has revised its **growth figures** for recent quarters to slightly lower rates.
- **The consumer price index** decreased by 0.3 percent in September, versus expectations of no change. Inflation in the twelve months ended in September was 2.8 percent, within the target range.
- **The Bank of Israel interest rate** remains unchanged. The BOI continued its non-transparent intervention in foreign-currency trading.
- **The unlinked government bond yield curve** fell in the short and medium ranges in October, mainly due to a decrease in expectations of an interest-rate hike by the BOI, rose in the long ranges.
- **World equity markets** fell moderately in October. The MSCI World index fell by 2 percent, the S&P 500 index fell by 2 percent, the NASDAQ index fell by 4 percent, and the MSCI Emerging Markets index was unchanged. The TA-100 index rose by 3 percent, or 4 percent in dollar terms.

This review contains four chapters:

- A. Developments in the Israeli Economy.
- B. Developments in the Capital Market.
- C. Developments in Inflation and Monetary Policy.
- D. Developments in the Global Economy.

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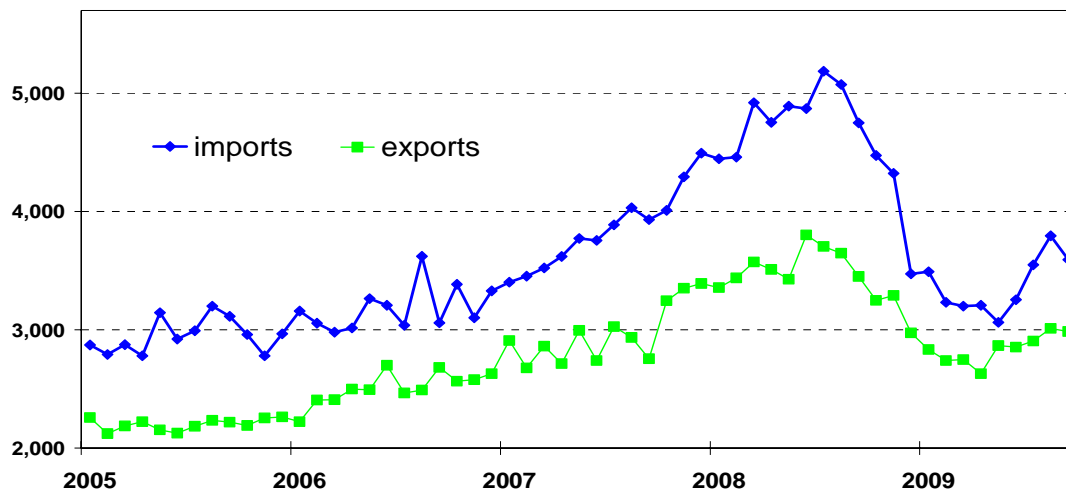


A. Developments in the Israeli Economy

Current indicators of economic activity painted a mixed picture over the last month. In September, imports and exports of goods declined, and tax revenues were slightly below the trajectory of the preceding months. By contrast, the number of incoming tourists increased. In August, the industrial production index and the trade and service sectors revenue index rose sharply. In our opinion, based on the economic indicators published so far, accelerated growth is emerging for the third quarter, as compared to the previous quarter. The initial GDP estimates will be published on November 16th.

Exports of goods (excluding diamonds, ships, and aircraft; in dollar terms) decreased by 1 percent in September and by 9 percent in the twelve months ended in September. Imports of goods decreased by 5 percent in September and by 17 percent in the twelve months ended in September. The monthly trade deficit decreased to USD 0.6 billion.

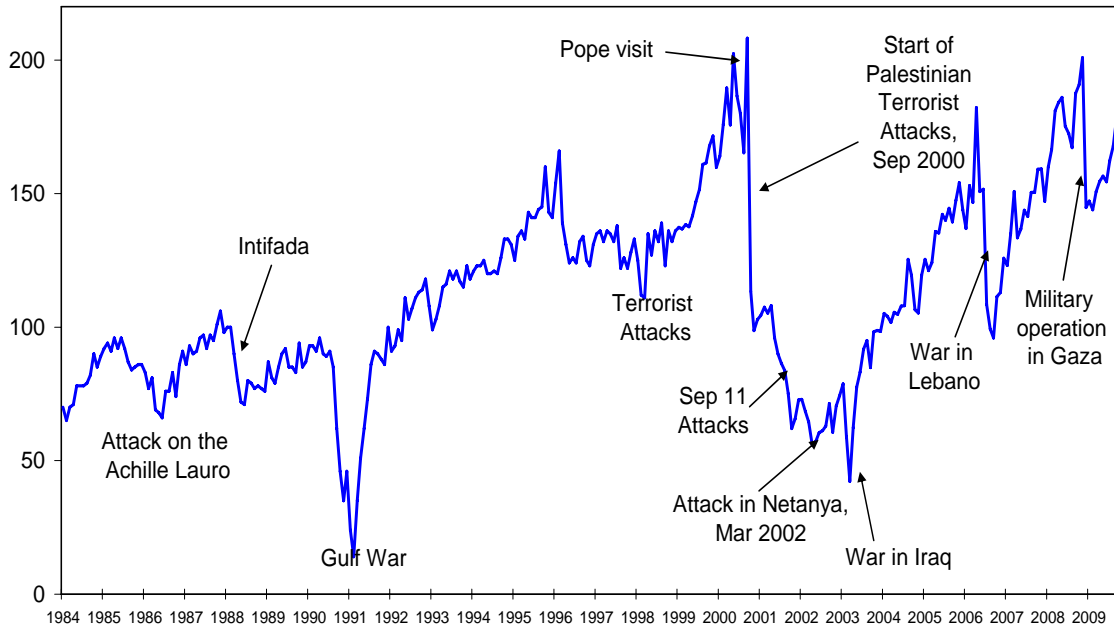
Exports and Imports of Goods
(US\$ millions per month, excl. diamonds, ships & airplanes)
Jan 2005 - Sep 2009



State tax revenues totaled ILS 15.3 billion in September, slightly below the trajectory of the preceding months. However, these revenues are expected to be higher than planned in the state budget in 2009 (ILS 173 billion), and there is a reasonable chance of revenues higher than the planned ILS 183 billion in 2010 as well.

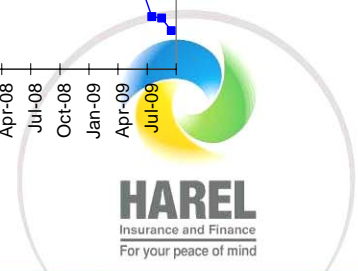
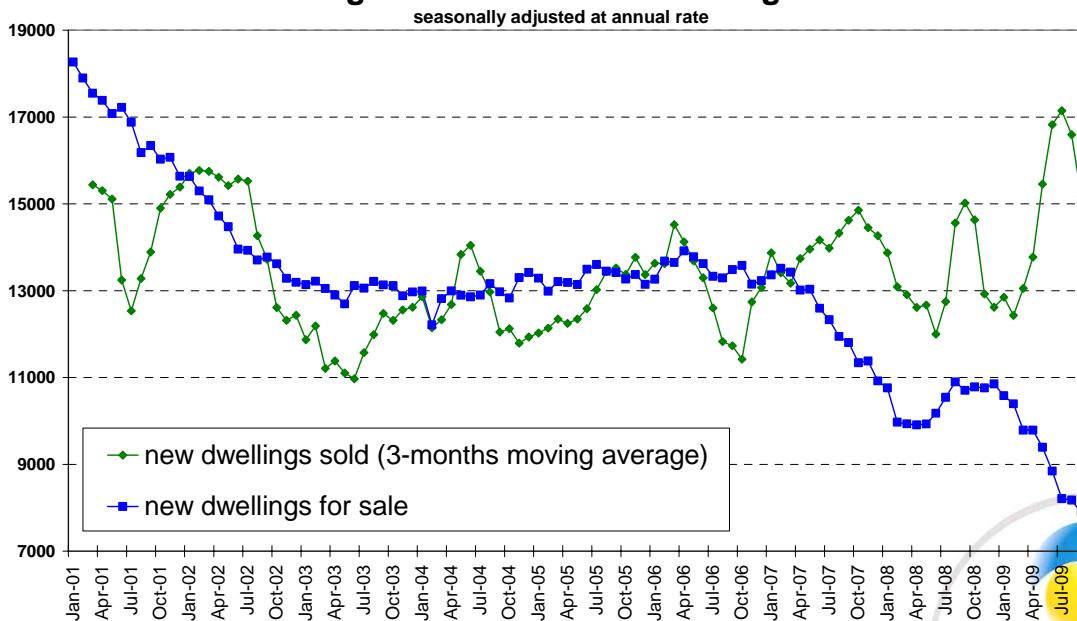
The number of incoming tourists by air grew by 6 percent in September.

Tourist Arrivals (thousands per month)

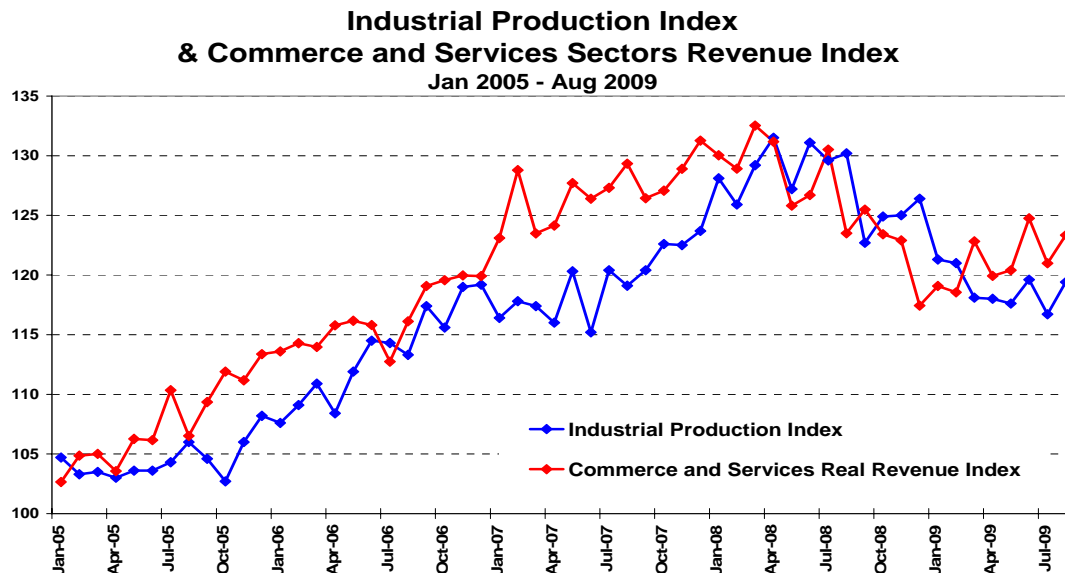


The number of new homes decreased by 4 percent in October and increased by 6 percent in the twelve months ended in October. The supply of homes for sale decreased by 4 percent as well, reaching a new low.

New Dwellings Sold and for Sale During The Period



The trade and service sectors revenue index rose by 2 percent in August and remained unchanged in the twelve months ended in August. The industrial production index rose by 2 percent in August and fell by 8 percent in the twelve months ended in August.



As a result, the Bank of Israel's composite index rose by 1.2 percent in September.

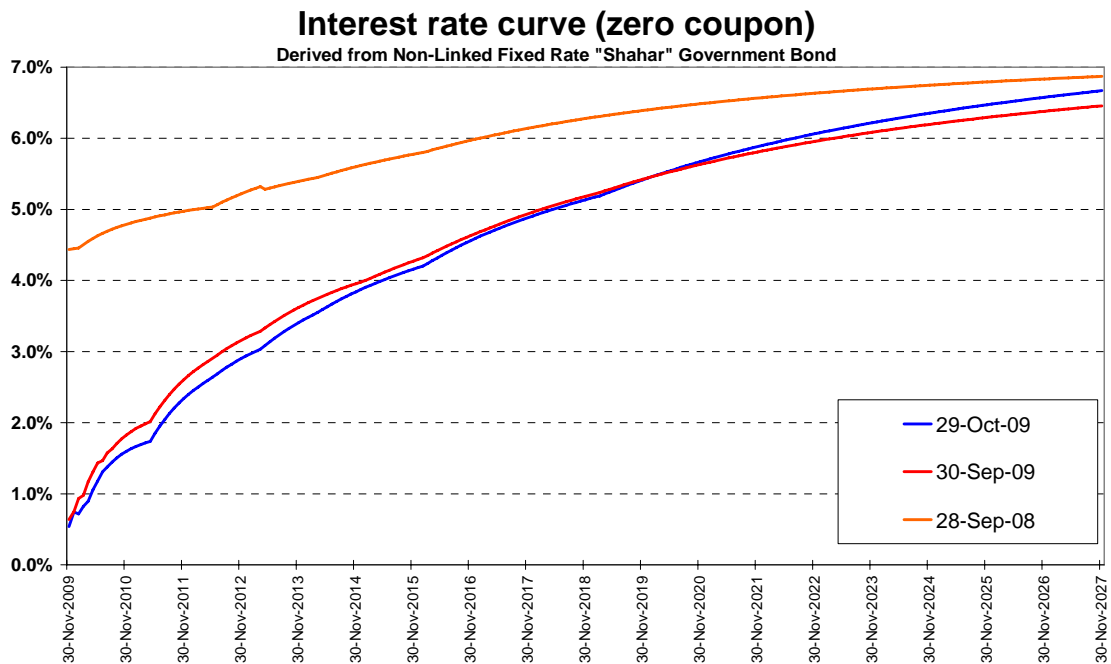
In the labor market, the number of employee positions decreased, along with a moderate increase in average nominal wages. The number of employee positions of Israelis decreased by 0.5 percent in July and by 1.6 percent in the twelve months ended in July. Average nominal wages for an employee position of Israelis grew by 0.6 percent in July and by 2.3 percent in the twelve months ended in July, with a 1.1 percent decrease in real wages.

Israel's Central Bureau of Statistics has adjusted growth figures for recent quarters downward somewhat. GDP grew at an annualized rate of 0.8 percent in the second quarter of 2009, versus 1.0 percent in the previous estimate. Business product rose by only 0.9 percent, versus 1.3 percent in the previous estimate, while exports grew at an annualized rate of 14.5 percent, versus 26.4 percent in the earlier estimate. By contrast, private and public consumption figures were revised upward. GDP in the first quarter of 2009 decreased by an annualized 3.3 percent, versus 3.2 percent in the previous estimate.

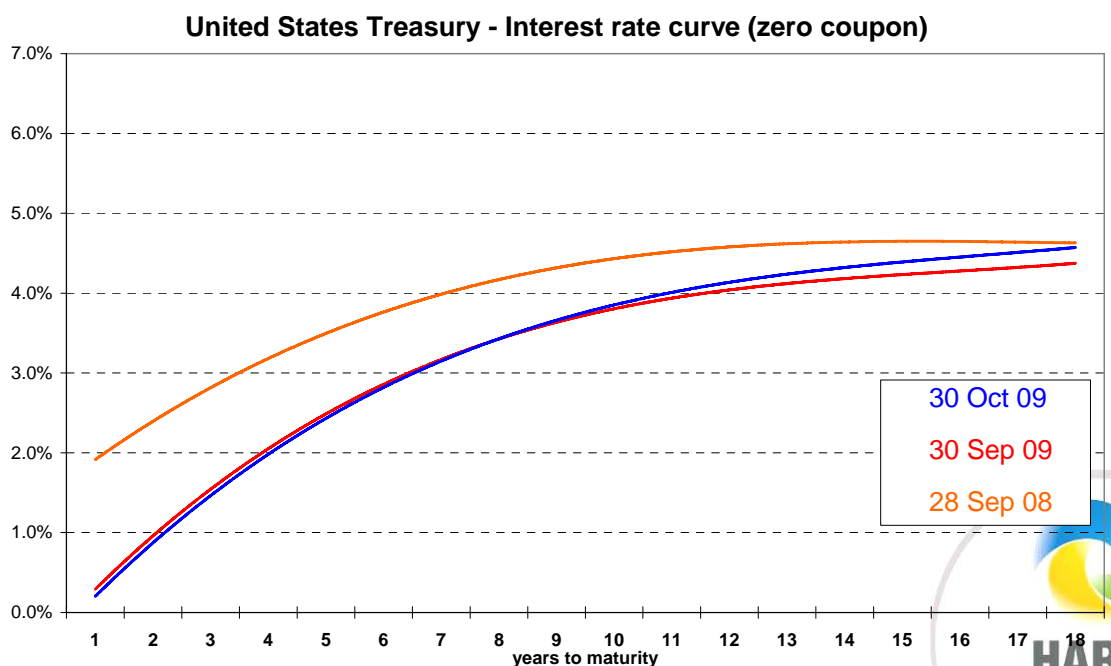
B. Developments in the Capital Market

Bond Market

The unlinked government bond yield curve fell in the short and medium ranges in October, mainly due to a decrease in expectations of an interest-rate hike by the BOI, rose in the long ranges.

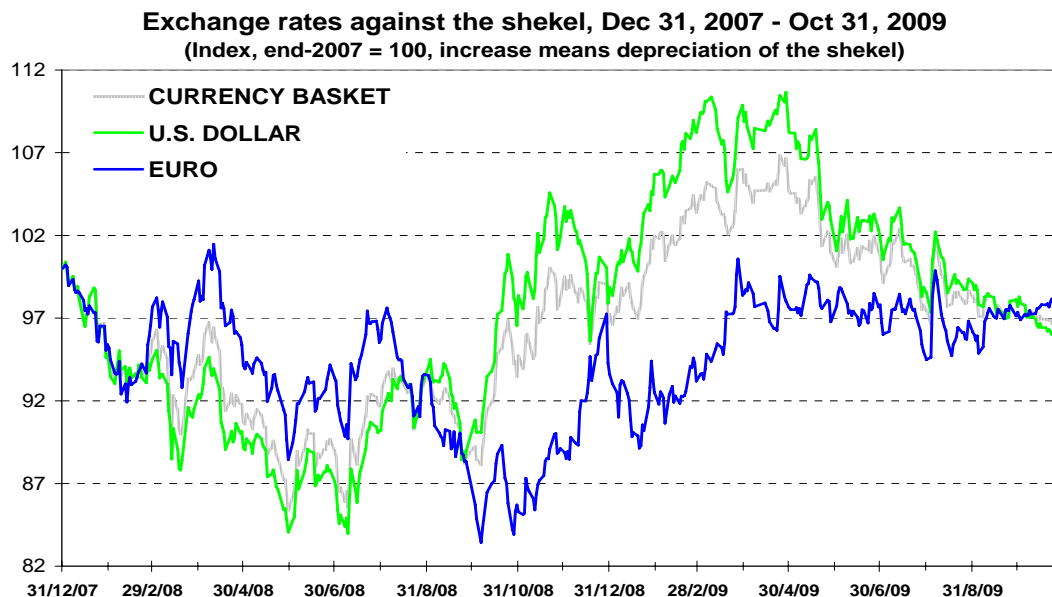


The US government bond yield curve rose in the long range during October.



Exchange Rates

The shekel weakened by 1 percent against the currency basket, the Dollar and the Euro in October.

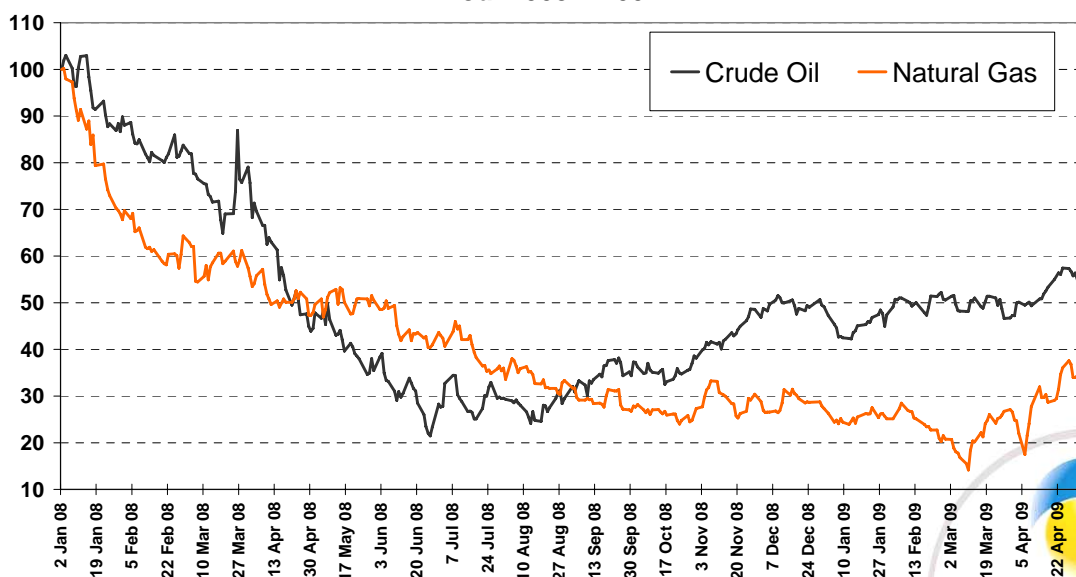


Energy prices

The price of a WTI oil barrel rose by 10 percent in dollar terms and by 11 percent in euro terms in October. The price of natural gas rose by 39 percent during the same time period.

Oil and Gas prices

Jul 2008 = 100



Stock Markets

World equity markets fell moderately in October. The MSCI World index fell by 2 percent, the S&P 500 index fell by 2 percent, the NASDAQ index fell by 4 percent, and the MSCI Emerging Markets index was unchanged. The TA-100 index rose by 3 percent, or 4 percent in dollar terms.

Israel's risk premium, based on the 10-year CDS spread, was 1.1 percent at the end of October, similar to the end of the preceding month.

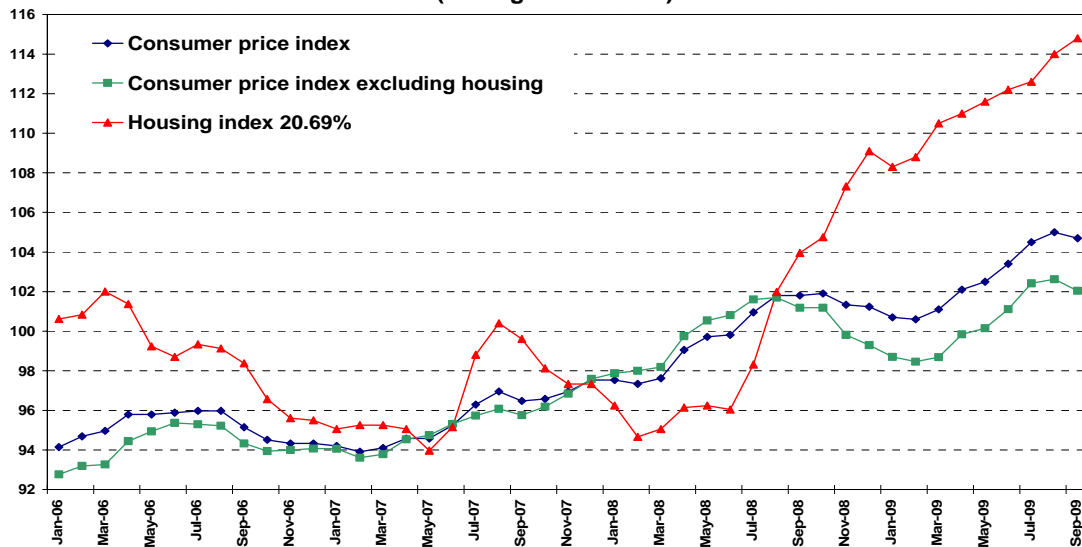
Israel's risk premium according to the CDS spread



C. Developments in Inflation and Monetary Policy

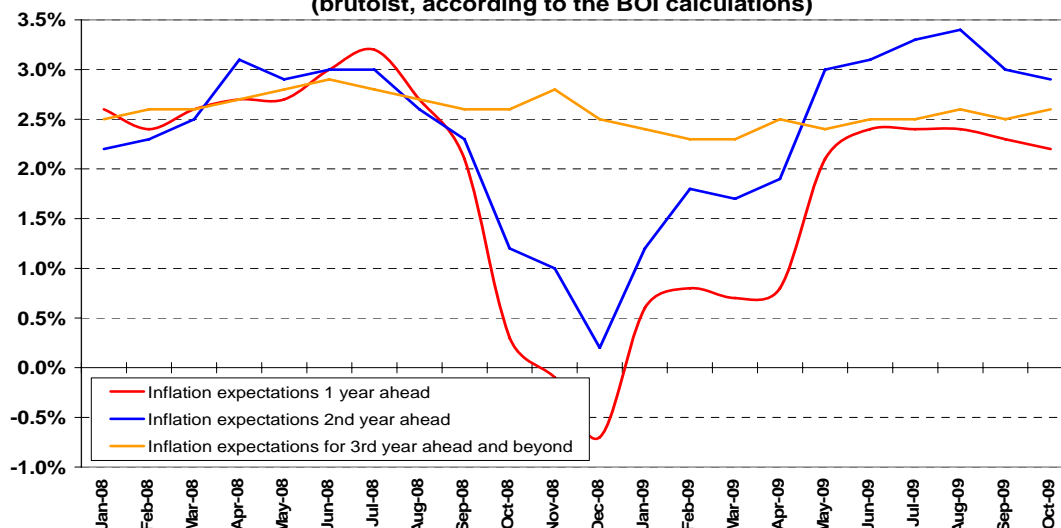
The **consumer price index** fell by 0.3 percent in September, versus the expectation of no change. Inflation in the twelve months ended in September totaled 2.8 percent, within the inflation target range. **Housing prices** continued to rise in September, in contrast to the trend of the other CPI items, which did not gain in price at all over the last year despite the tax hikes of recent months (which we estimate contributed 1.0 to 1.5 percentage points to inflation). The increase in the housing item, which represents rent prices, is similar to the increase in housing prices – over 10 percent in the course of the last year.

Consumer price index and the Housing price index (Average 2008 = 100)



Inflation expectations, according to calculations by the Bank of Israel, on average between mid-September and mid-October stood at 2.2 percent for the first year, 2.9 percent for the second year, and 2.6 percent from the third year forward. This is another slight decrease compared to the preceding months.

Inflation expectations derived by the capital market (brutoist, according to the BOI calculations)



The amount of **means of payment** decreased by 1 percent in September, following many months of gains. This figure grew by 60 percent in the twelve months ended in September, a very high rate in an international comparison, but slightly less than in the preceding month.

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The BOI purchased USD 1.6 billion in September, versus USD 4 billion in August and USD 2 billion each month (in regular daily purchases) until July.

The Bank of Israel interest rate remained unchanged at 0.75 percent, in line with our estimates. The BOI's announcement contained no clues regarding its future interest-rate policy. Similar to last month, the BOI noted three main reasons for its decision:

- Inflation, excluding seasonal effects and the effects of indirect taxes, has been in the middle of the target range in recent months; inflation expectations remained slightly above the midpoint of the target range again this month.
- The economic recovery continues in Israel and globally, but a negative GDP gap and a relatively high unemployment rate are still tempering inflationary pressures.
- The interest rates of the central banks in the leading economies are low, and are expected to remain so in the coming few months.

From our perspective, all three factors were already true in the last two months, and will still be true in the next few months. The BOI needs to continue to raise the interest rate in the near future, but at a moderate pace. An increase of 0.25 percentage points at two- or three-month intervals seems reasonable given the economic conditions, the considerable increase in the money supply, world monetary policy, and the goal of preventing pressures towards rapid appreciation of the shekel. If there are no surprises from the exchange rate or the forthcoming CPI, we expect a 0.25-point interest-rate hike next month.

D. Developments in the Global Economy

Growth forecasts for advanced economies

The *Economist* has published its monthly **Consensus Forecast** of growth rates in the advanced countries. No significant changes in the forecasts emerged, following the increases of the previous month.

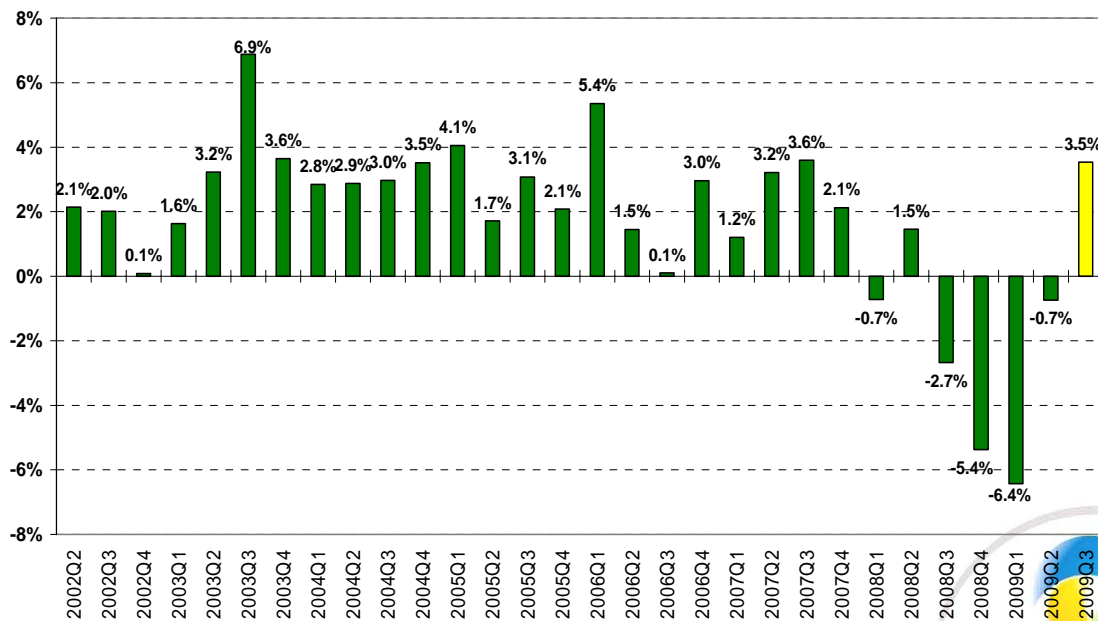
United States

Current indicators of economic activity painted a mixed picture over the last month. Third-quarter **growth in the United States** was surprisingly positive, but the sharp decline in **private consumption** in September raised questions about future growth.

GDP grew at an annualized rate of 3.5 percent in the third quarter of 2009, according to an initial estimate, above the expected 3.2 percent. This positive figure marks the end of the recession that began in late 2007, which was the most severe slump since the Great Depression of the 1930s. **Private consumption** grew by 3.4 percent in the third quarter, more than expected, following a 0.9 percent decline in the second quarter.

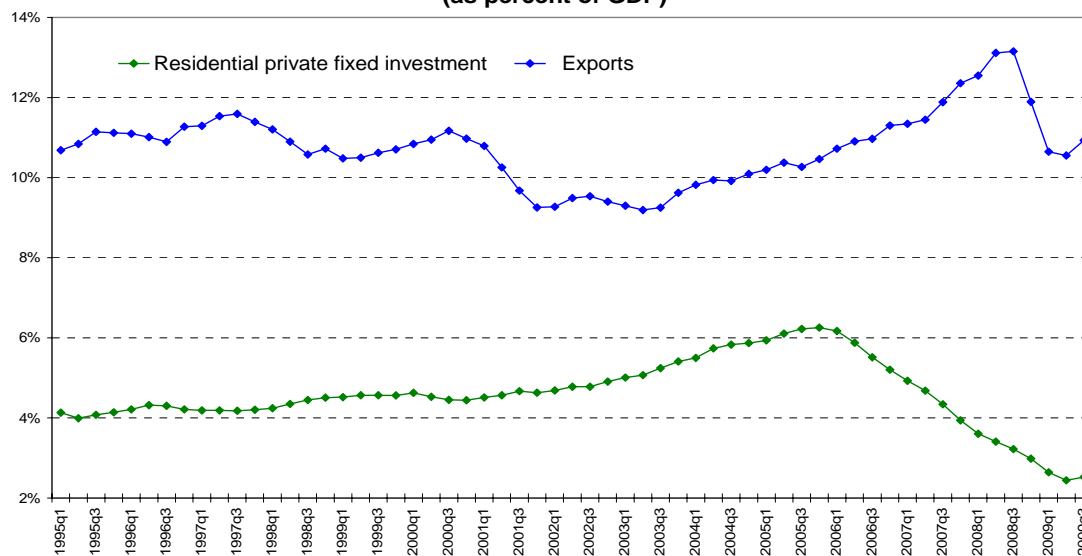
The U.S. Economy

(Real quarterly growth rates, seasonally adjusted at annual rate)



The composition of the American GDP also changed significantly. After 4.5 years of contraction of investments in construction as a percentage of GDP, a moderate increase occurred in the third quarter, signaling the end of the crisis in the housing market. Exports also grew as a percentage of GDP, following a sharp decline in the preceding three quarters, due to the improvement in the global economy and the effects of the weakening of the dollar on the competitive power of American exports.

US: Exports and Residential investment
(as percent of GDP)



Real private consumption fell by 0.6 percent in September, following a sharp 1.0 percent increase in August, due to the end of the stimulus plan for motor vehicle purchases in August. In the last five months, real private consumption increased at a quite reasonable annualized average rate of 1.9 percent; however, during this period the fiscal stimulus plan had a positive effect, and this rate may not be sustainable going forward.

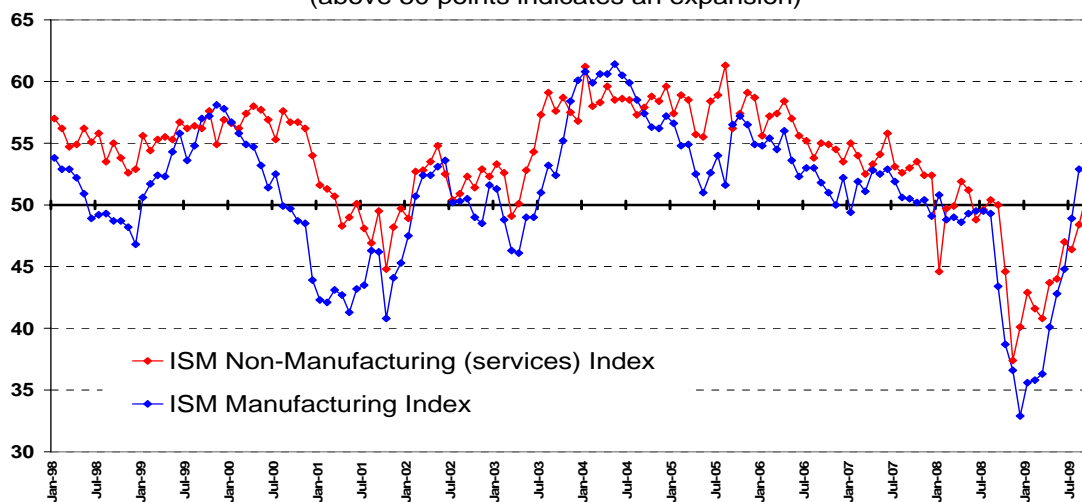
The rate of savings rose to 3.3 percent in September, from 2.8 percent in August.

Core prices of private consumption rose by 0.1 percent again in September. This means that inflation in the United States has remained low and stable, and there are no signs of high inflation or of deflation at this stage.

The consumer price index rose by 0.2 percent in September, as expected, but the wholesale price index surprisingly fell by 0.6 percent.

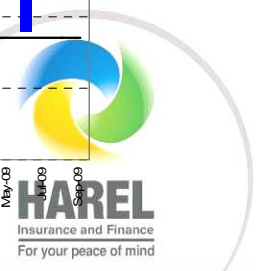
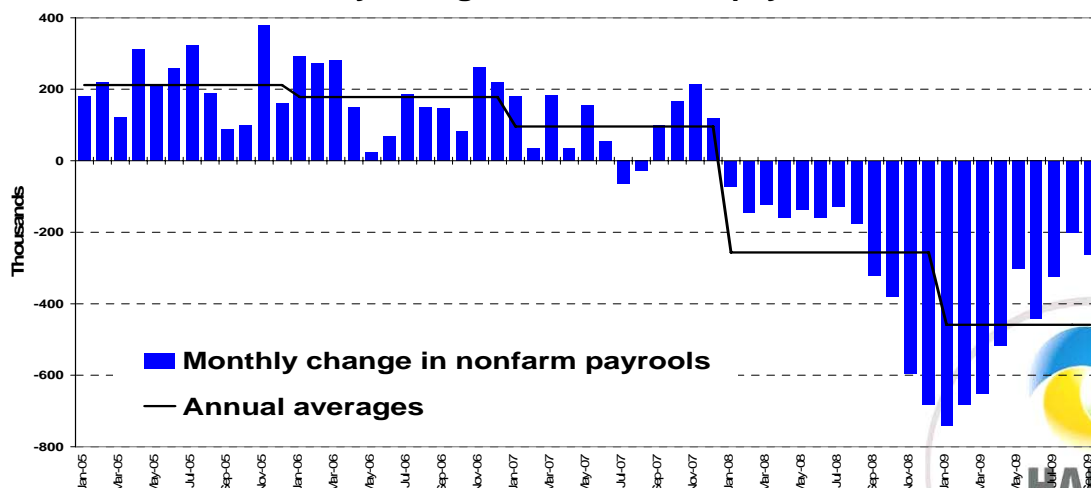
The ISM manufacturing sector index stood at 52.6 points in September, above the 50-point mark (indicating expansion), but lower than expected. The ISM service sector index was at 50.9 points in September, above expectations. This index was higher than 50 points, indicating expansion of activity – though moderate – for the first time since September 2008.

The Institute for Supply Management Index (above 50 points indicates an expansion)



The Employment Report for September indicates significant continued weakness in the labor market. The number of employed persons decreased by a steeper-than-expected 263,000, while data for previous months were revised downward. The unemployment rate was 9.8 percent, a 26-year record.

Monthly Change in U.S. nonfarm payrolls



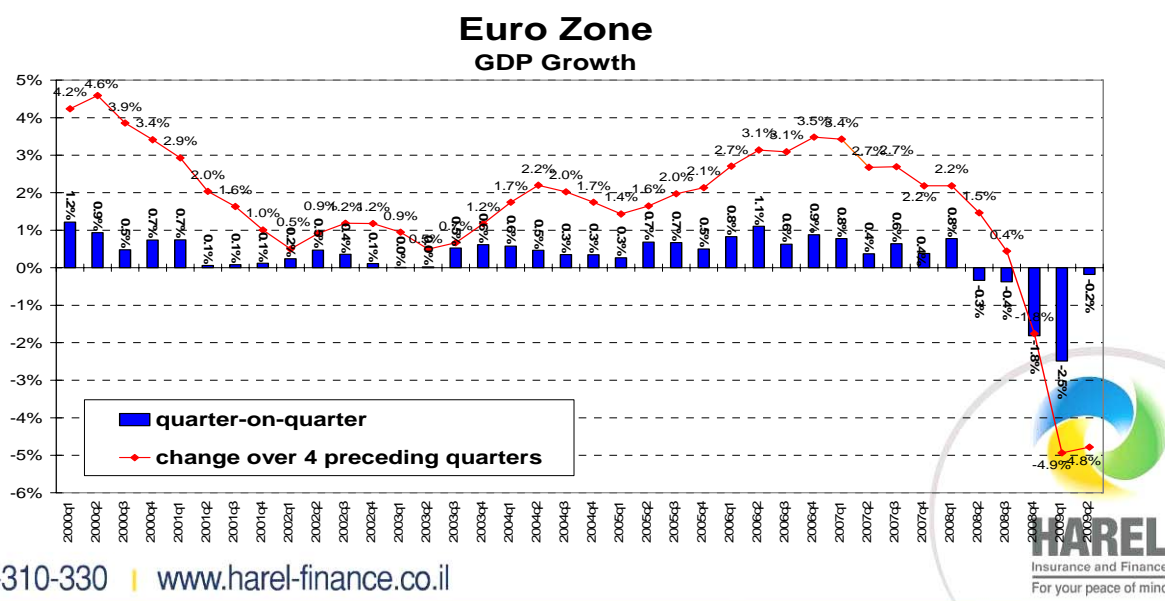
Retail sales declined by 1.5 percent in September, better than expected, following a sharp increase in the previous month.

Housing-market figures that were published in the last month were mixed. Construction starts and permits showed slight changes in September, in contrast to expectations of an increase. Sales of existing homes grew by 9 percent in September, more than expected. The S&P Case-Shiller index of housing prices in twenty major US cities rose by 1.2 percent in September, above expectations. Sales of new homes were disappointing in September, falling by 4 percent, while data for the preceding months were adjusted downward.

Euro Zone

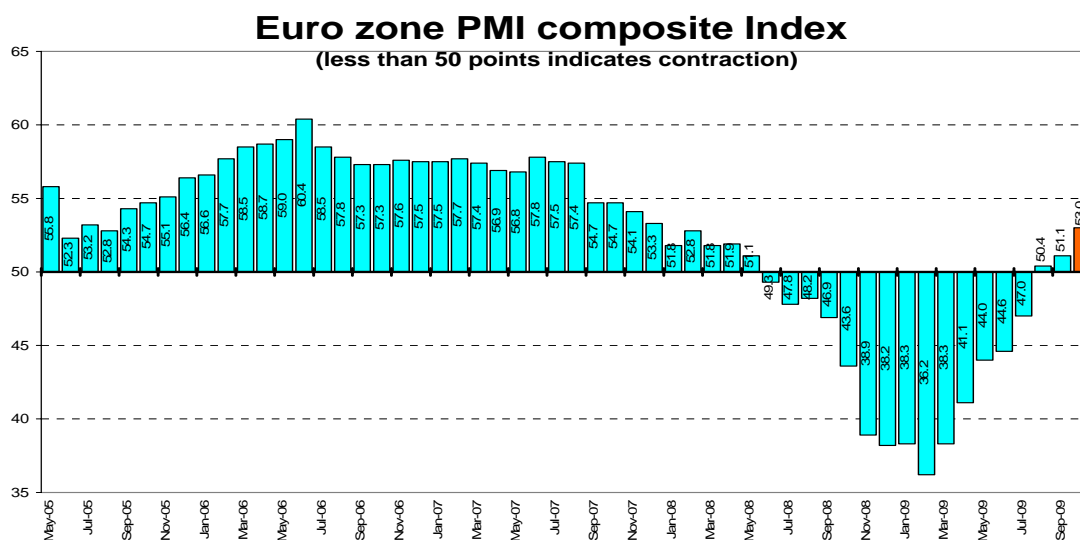
The unemployment rate in the euro zone rose by an additional 0.1 percent in September, to 9.7 percent, in line with expectations, versus 7.7 percent in September last year. There are large differences in unemployment rates among countries within the euro zone: unemployment was low at 3.6 percent and 4.8 percent in the Netherlands and Austria, respectively, but high at 19.3 percent in Spain.

According to updated data, GDP in the euro zone contracted by 0.2 percent in the second quarter of 2009 (0.7 percent in annualized terms), a sharper decline compared to the initial estimate.



Inflation stood at a negative 0.1 percent in October, according to an initial estimate, in line with advance estimates. The ECB left the interest rate unchanged at 1.0 percent, as expected.

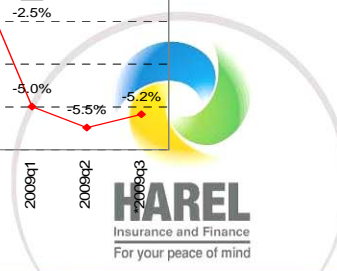
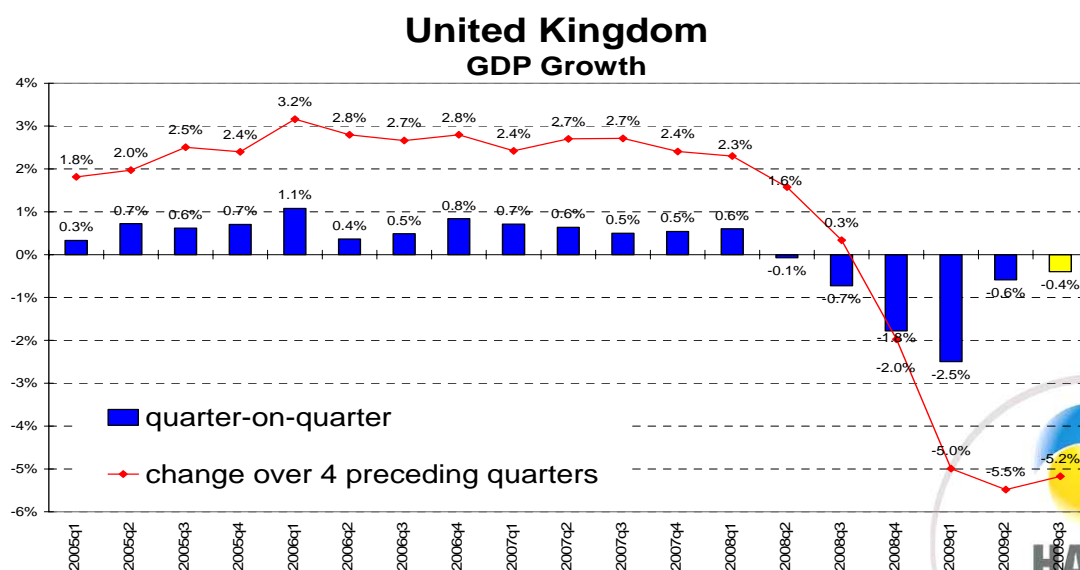
The euro zone purchasing managers' index was at 53 points in September, according to an initial estimate, above expectations.



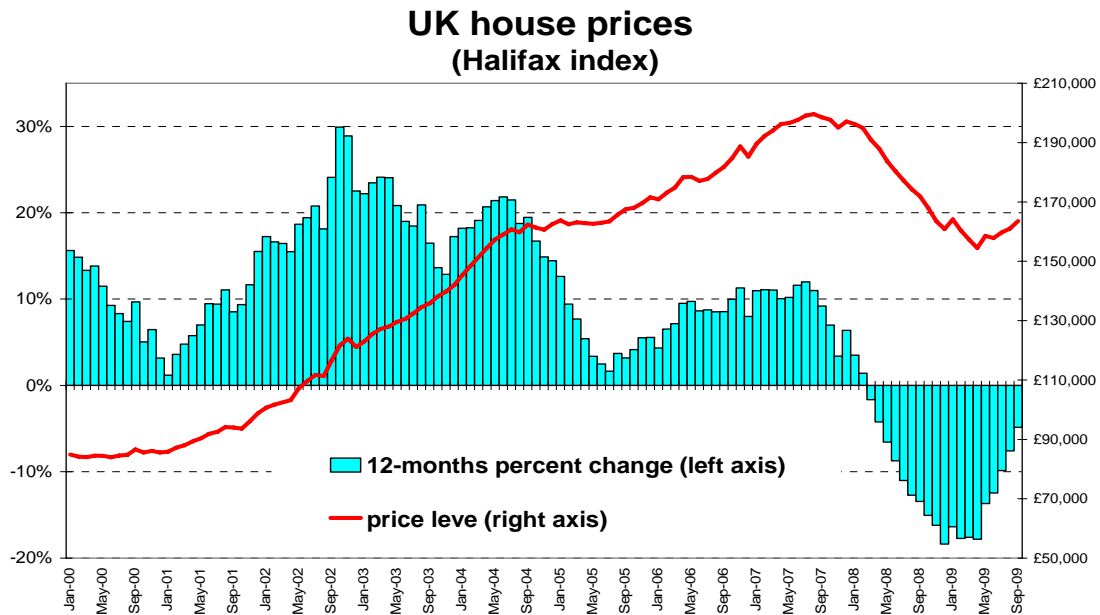
Retail sales declined by 0.2 percent in August, a smaller than expected decline.

United Kingdom

In contrast to expectations, the British economy continued to contract, for the sixth consecutive quarter. According to initial estimates, GDP declined by 0.4 percent (1.6 percent annualized) in the third quarter of 2009.



The UK's Halifax house price index rose by 1.6 percent in September, above expectations. Housing prices are still 18 percent below their peak level, despite three consecutive months of gains.



The UK central bank left the interest rate unchanged at 0.5 percent, as expected.

Important Announcements in the Coming Month

Title	date	Day	Time	Link
Euro zone PMI index	2 Nov	Mon	11:00	www.markiteconomics.com
US, ISM manufacturing index	2 Nov	Mon	17:00	www.ism.ws
US, ISM Services index	4 Nov	Wed	17:00	www.ism.ws
US, interest rate decision	4 Nov	Wed	21:15	http://www.federalreserve.gov
Euro Zone, Retail sales	5 Nov	Thu	12:00	www.ec.europa.eu/eurostat
Israel, average wages	5 Nov	Thu	13:00	www1.cbs.gov.il/reader
UK, interest rate decision	5 Nov	Thu	14:00	www.bankofengland.co.uk
Euro zone, interest rate decision	5 Nov	Thu	14:45	www.ecb.int
US, employment report	6 Nov	Fri	15:30	www.bls.gov
Israel, foreign trade	11 Nov	Wed	13:00	www1.cbs.gov.il/reader
Israel, incoming tourists	12 Nov	Thu	13:00	www1.cbs.gov.il/reader
Euro zone, CPI	13 Nov	Fri	12:00	www.ec.europa.eu/eurostat
Euro zone, Q3 initial estimate	13 Nov	Fri	12:00	www.ec.europa.eu/eurostat
Israel, CPI	15 Nov	Sun	18:30	www1.cbs.gov.il/reader
Japan, Q3 initial estimate	16 Nov	Mon	01:50	http://www.stat.go.jp/english/
Israel, Q3 initial estimate	16 Nov	Mon	13:00	www1.cbs.gov.il/reader
US, retail sales	16 Nov	Mon	15:30	www.census.gov/svsd/www/adseries.html
US, CPI	18 Nov	Wed	15:30	www.bls.gov
US, housing starts and permits	18 Nov	Wed	15:30	www.census.gov/pub/const
Israel, Industrial production index and trade and service sectors revenue index	19 Nov	Thu	13:00	www1.cbs.gov.il/reader
US, Sales of existing homes	23 Nov	Mon	17:00	www.realtor.org/Research.nsf/Pages/EHSdata
Israel, BOI interest rate decision	23 Nov	Mon	17:30	www.bankisrael.gov.il
Israel, Q3 initial estimate	24 Nov	Tue	15:30	www.bea.gov
US, case-shiller index	24 Nov	Tue	16:00	http://www2.standardandpoors.com
UK, Q3 initial estimate	25 Nov	Wed	11:30	www.statistics.gov.uk
Israel, employment survey Q3	25 Nov	Wed	13:00	www1.cbs.gov.il/reader
US, Q3 initial estimate	25 Nov	Wed	15:30	www.bea.gov
US, Michigan University consumer confidence index	25 Nov	Wed	17:00	www.sca.isr.umich.edu
US, new home sales	25 Nov	Wed	17:30	www.census.gov/const/www/newressalesindex.html
Israel, New dwelling sold in private sector	26 Nov	Thu	13:00	www1.cbs.gov.il/reader
Euro zone, CPI estimate	30 Nov	Mon	12:00	www.ec.europa.eu/eurostat



This review is posted online at www.harel-finance.co.il/macro in Hebrew

and at <http://www.harel-group.com/finance.html> in English.

Please address comments or questions to Mr. Ofer Klein at
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