

Monthly Macroeconomic Review

August 3, 2009

- **Indicators of domestic economic activity** point to a continued negative trend in the second quarter, though at a more moderate rate. Imports and exports of goods increased in June, and the number of new homes sold rose significantly; however, incoming tourism decreased slightly. The industrial production index and the trade and service sectors revenue index decreased in May.
- **The consumer price index** rose by 0.9 percent in June, far above expectations. The housing item showed a surprising 0.5 percent increase despite the appreciation of the shekel during the relevant period. Inflation in the twelve months through June reached 3.6 percent.
- **The Bank of Israel interest rate** remained unchanged at 0.5 percent, as expected. The BOI will end its government bond purchasing plan on August 5, while continuing daily purchases on the foreign-currency market. The BOI also announced that it does not intend to sell the bonds acquired.
- **The unlinked government bond yield curve** rose in the short and medium terms in July. The surprising June CPI contributed to the increase in yields.
- July was a positive month for **world equity markets**, supported by the publication of better-than-expected financial statements by several major US financial companies and by the upward revision of growth forecasts for 2010. Overall for the month, the MSCI World index rose by 8 percent, the S&P 500 index rose by 7 percent, the NASDAQ index gained 8 percent, and the MSCI Emerging Markets index rose by 11 percent. The **TA-100 index** rose by 10 percent, or 14 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.



A. Developments in the Israeli Economy

The Central Bureau of Statistics has adjusted first-quarter GDP data slightly upward. The **growth rate** was revised to a negative 3.7 percent, from a negative 3.9 percent in the previous estimate, with a more moderate decline in exports.

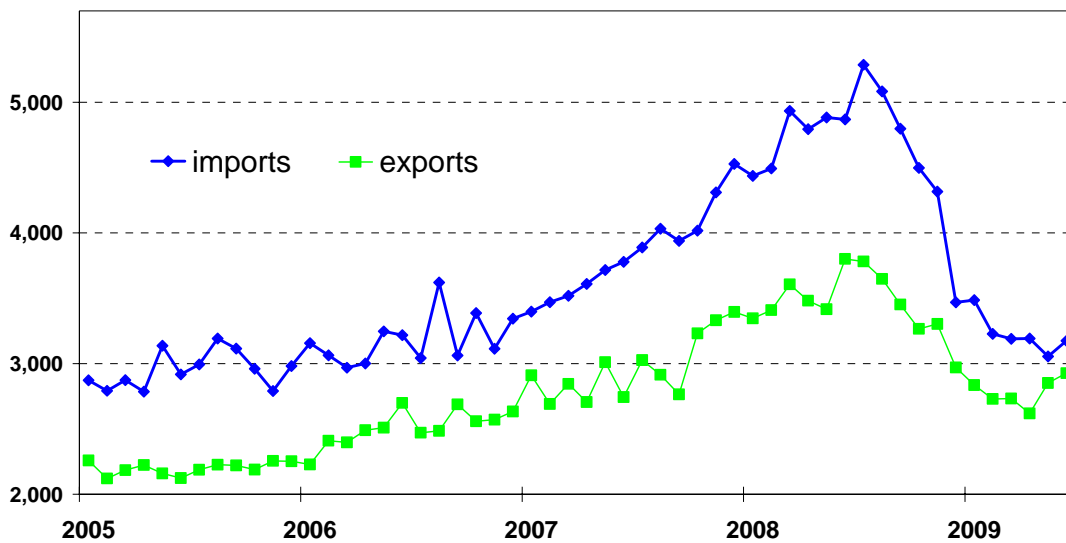
According to indicators published to date, it appears that GDP will decrease again for the second quarter of 2009, though more moderately than in the first quarter, mainly thanks to the relative improvement in exports.

The BOI's **Companies Survey** for the second quarter of 2009 indicated continued contraction of economic activity (a negative net balance), though at a slower pace compared to the preceding two quarters. Declines in activity were noted in all sectors, with the exception of construction and communications.

Exports of goods took a positive turn in May and June. Excluding diamonds, ships, and aircraft, exports of goods in dollar terms rose by 3 percent in June, following a sharp upward revision of the previous month's figures, which now point to a 9 percent gain in May. Nonetheless, exports of goods decreased by 23 percent in the twelve months ended in June. Some of the increase in this figure in the last few months may have derived from the initiation of exports from the new Intel plant. **Imports of goods** grew by 4 percent in June, but decreased by 35 percent in the twelve months ended in June.

Exports and Imports of Goods

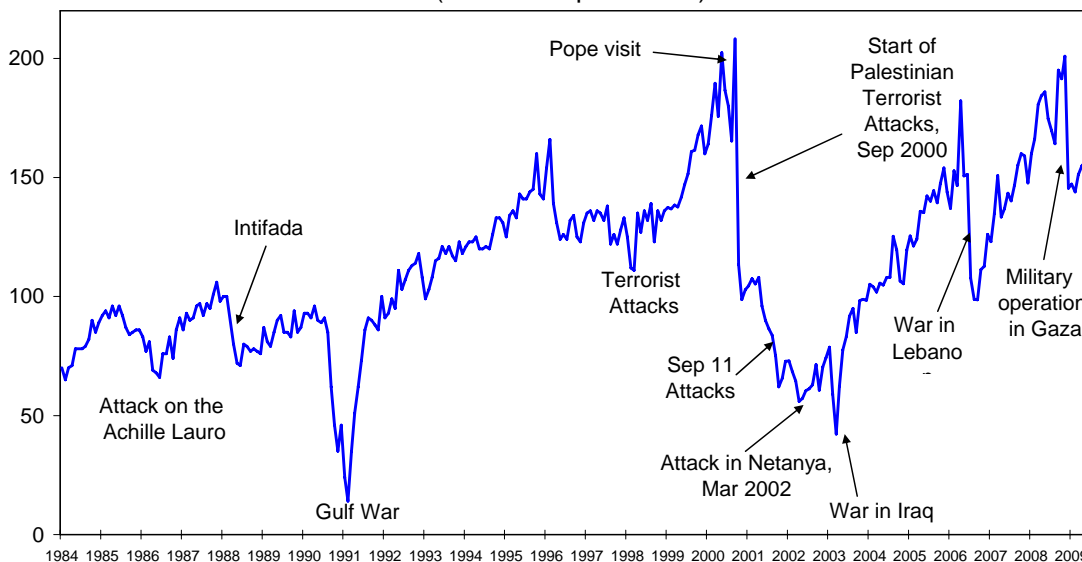
(US\$ millions per month, excl. diamonds, ships & airplanes)
January 2005 - June 2009



Incoming tourists by air decreased by 1.8 percent in June.

Tourist Arrivals

(thousands per month)

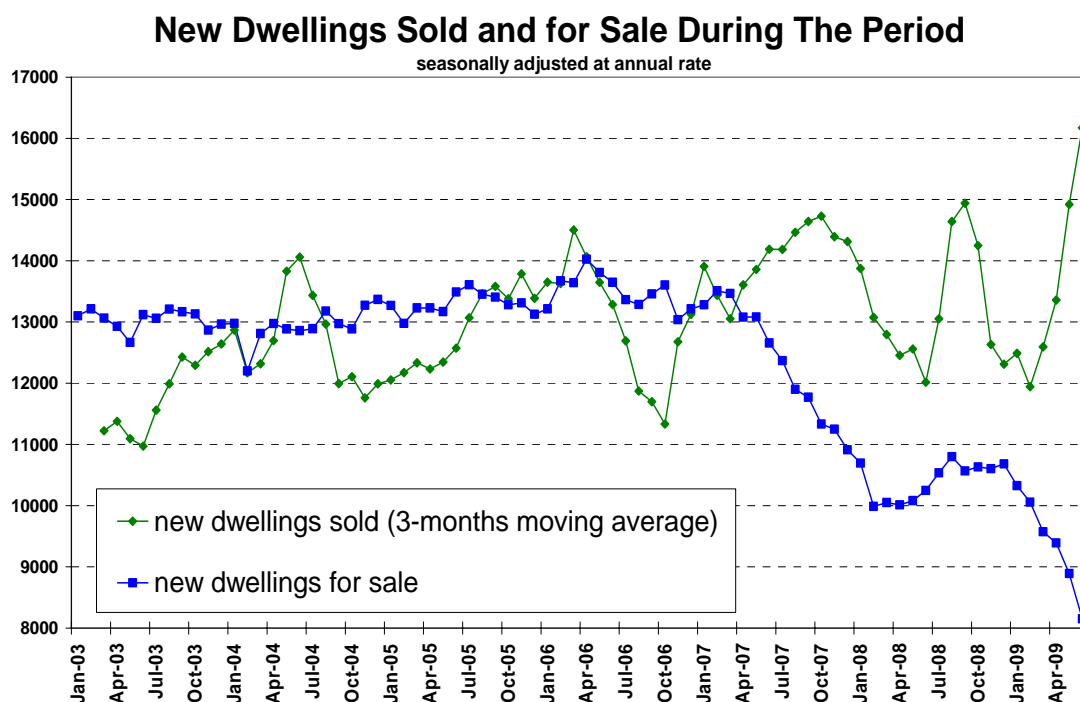


State tax revenues totaled ILS 13.0 billion in June, slightly below the trajectory consistent with the amended forecast in the state budget.



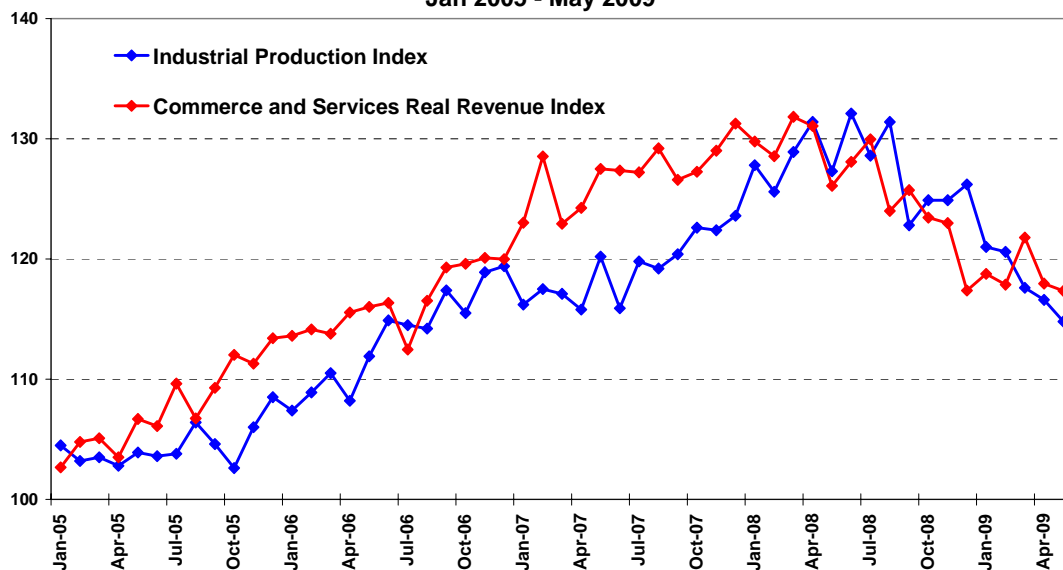
The Prime Minister's reversal of the decision to revoke the VAT exemption on fruits and vegetables sends an additional signal of the current government's inability to get unpopular but economically sound decisions passed in Knesset. It also increases the questions surrounding the expected budget deficit in 2010 and in the subsequent years. In our opinion, maintaining the declared deficit target for 2010 (5.5 percent of GDP) and lowering it to the declared target for 2011 (3 percent of GDP) will require further tax hikes and/or cancellation of the planned cuts in income tax for individuals and in corporate tax.

The number of new homes sold grew by 16 percent in June and by 47 percent in the twelve months ended in June, with most of the increase occurring in the last three months. However, the number of homes for sale decreased by 8 percent in May and by 20 percent in the twelve months ended in May. This figure may indicate continued upward pressure on housing prices.



Industrial production and trade and service revenues declined again in May. The **industrial production index** fell by 1.5 percent in May and 10 percent in the twelve months ended in May, while the **trade and service sectors revenue index** decreased by 0.5 percent in April and 7 percent in the twelve months ended in April.

**Industrial Production Index
& Commerce and Services Sectors Revenue Index**
Jan 2005 - May 2009

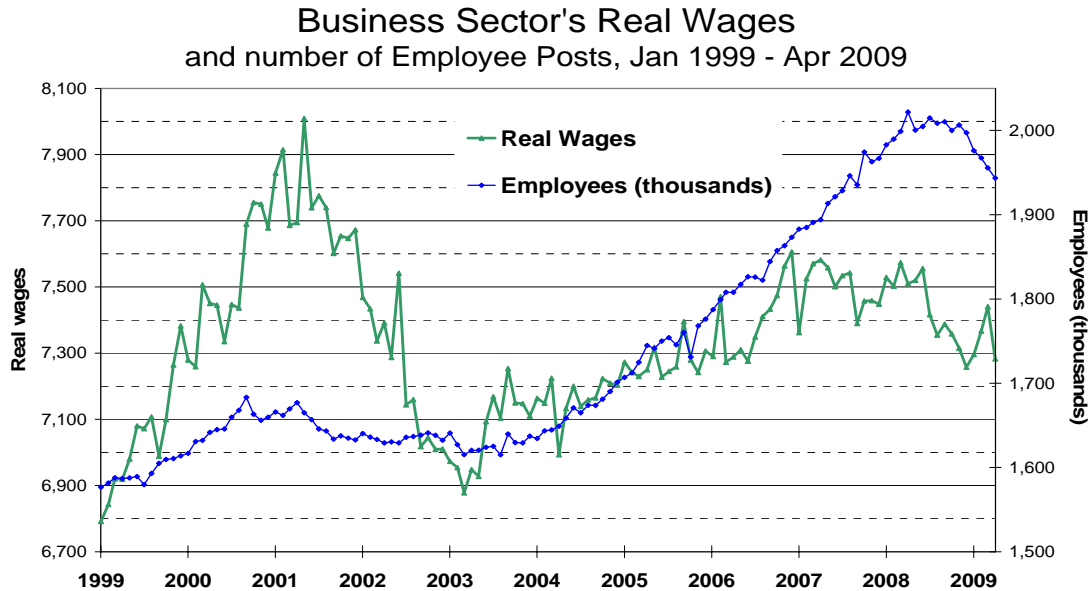


The Bank of Israel's **composite index** rose by 0.2 percent in June. This index decreased by 2.4 percent on average in the second quarter of 2009, following a 4.3 percent decrease in the first quarter.

The weakness in the labor market is worsening. The **number of jobs of Israeli workers** decreased by 0.6 percent in April and by 2.4 percent in the twelve months ended in April. **Average wages for an employee position of Israeli workers** decreased by 1.1 percent in April, and increased by 0.6 percent in the twelve months ended in April, with a real decrease of 2.5 percent.



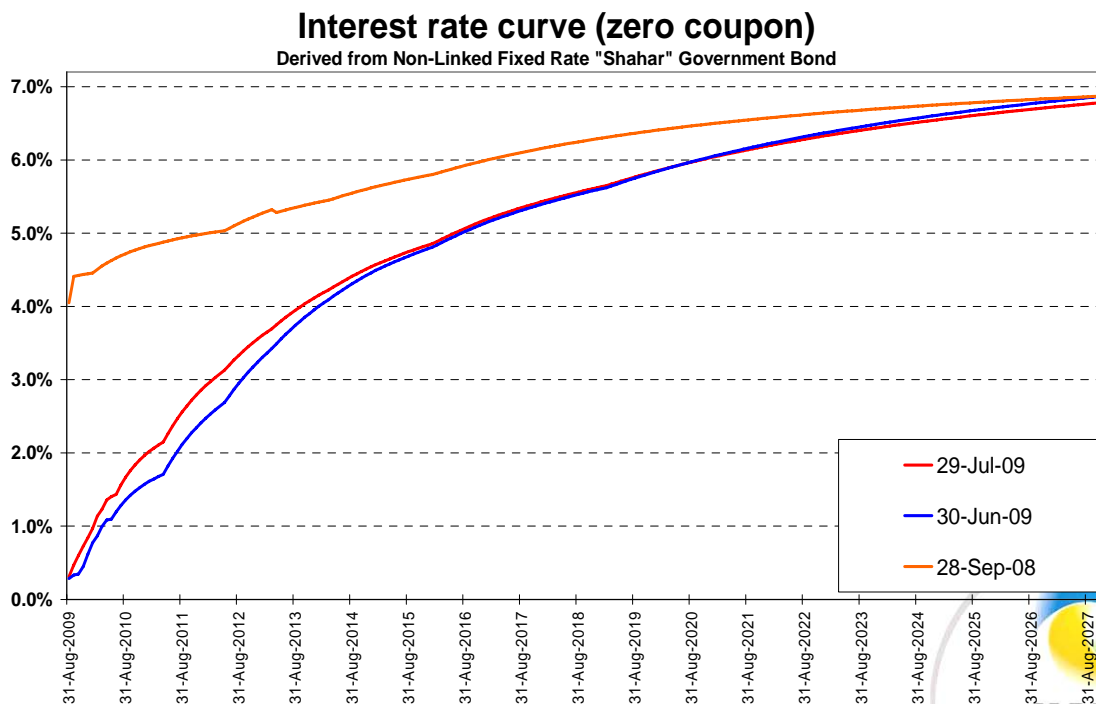
The number of employee positions in the **business sector**, including non-Israelis, decreased by 0.6 percent, while real wages declined by 2.1 percent.



B. Developments in the Capital Market

Bond Market

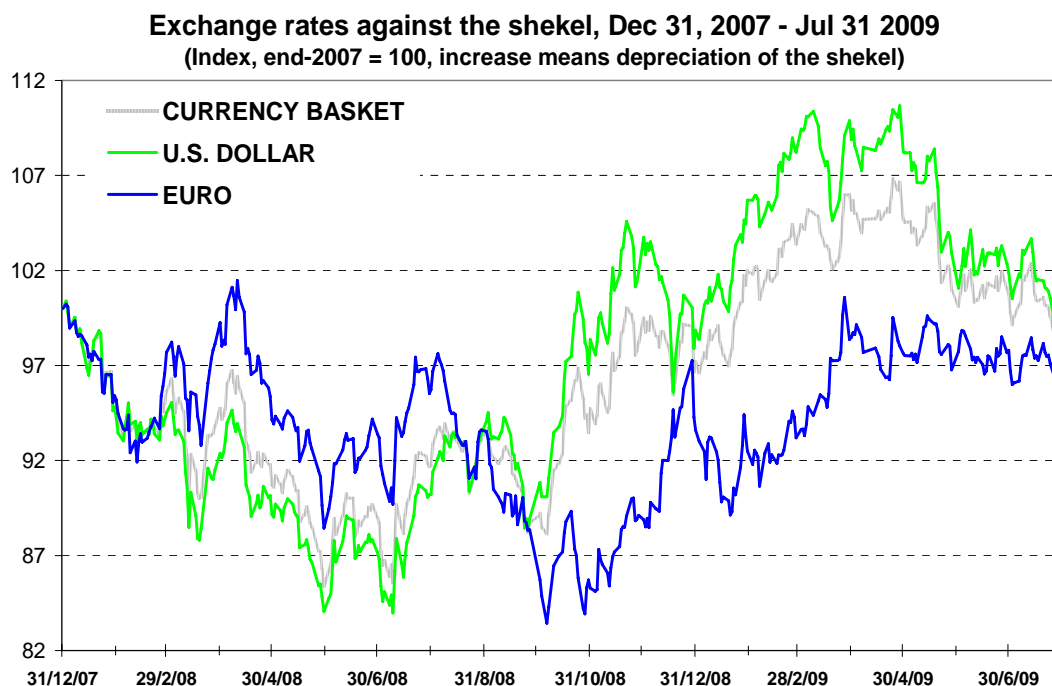
The unlinked government bond yield curve rose in the short and medium terms in July. The surprising June CPI contributed to the increase in yields.



The gap between unlinked and CPI-linked yields rose following the publication of the CPI last week, and now stands at 2.9-3.4 percent in the short and medium terms. In our opinion, the expectation reflected in this gap is justified for the coming year, but excessive for the subsequent years. We therefore see the unlinked segment as preferable to the linked segment in the medium durations (maturing in 2011 through 2015).

Exchange Rates

The shekel appreciated by 3 percent against the dollar, the euro, and the currency basket in July. Contributing factors included the estimates that the BOI will begin to raise the interest rate in the coming months and will stop its intervention in the foreign-currency market, due to the improvement in exports and the increase in inflation.

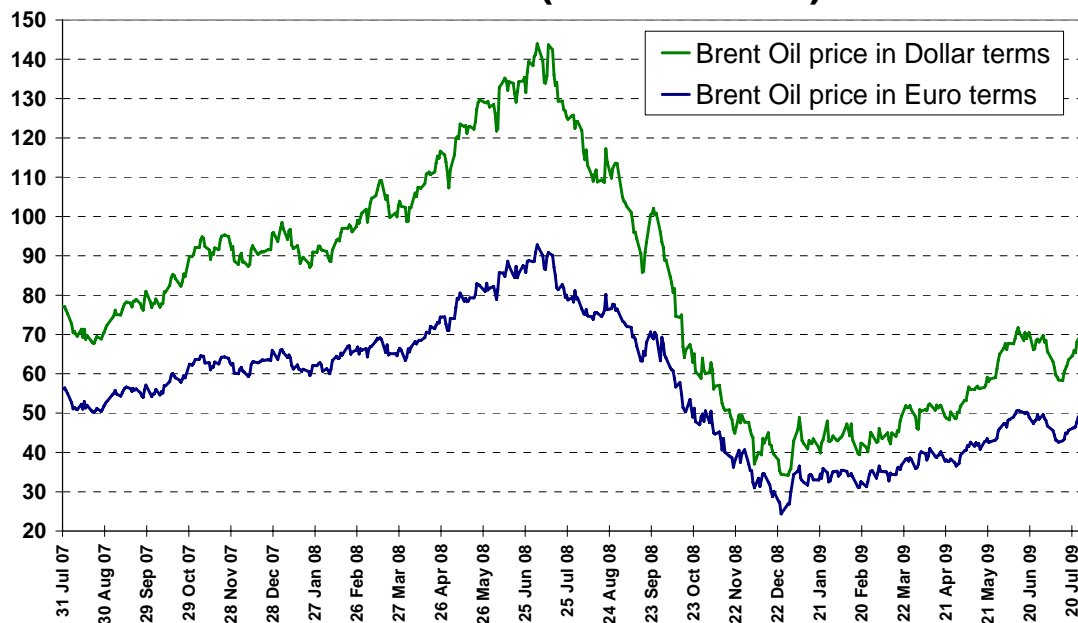


Oil Prices

The price of a Brent oil barrel rose by 4 percent in dollar terms and by 2 percent in euro terms in June.



Price of Oil (Brent barrel)



Stock Markets

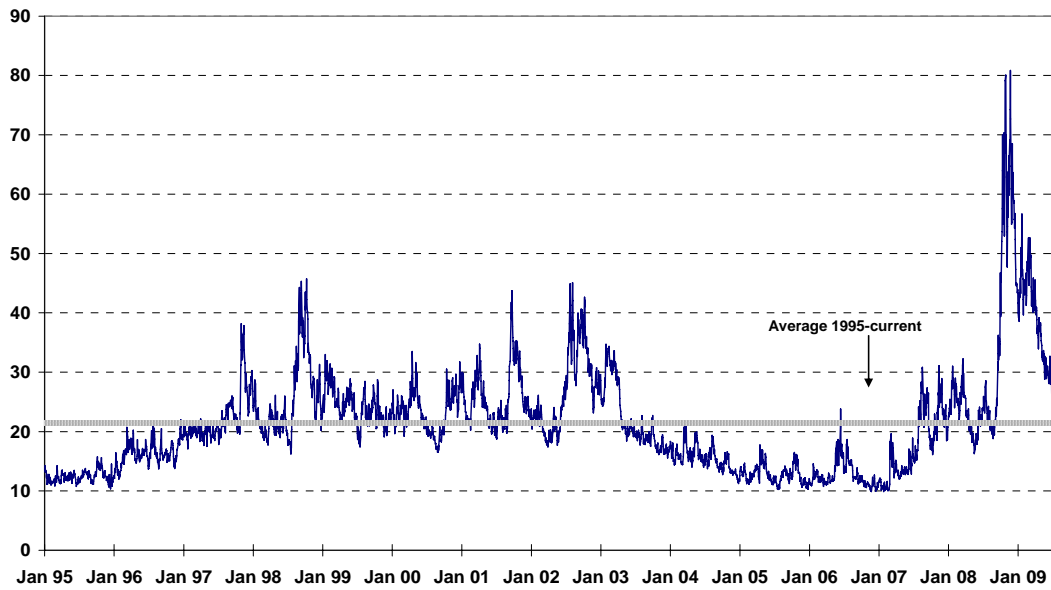
July was a positive month for **world equity markets**, supported by the publication of better-than-expected financial statements by several major US financial companies and by the upward revision of growth forecasts for 2010.

Overall for the month, the MSCI World index rose by 8 percent, the S&P 500 index rose by 7 percent, the NASDAQ index gained 8 percent, and the MSCI Emerging Markets index rose by 11 percent. The **TA-100 index** rose by 10 percent, or 14 percent in dollar terms.

The VIX index, a popular measure of implied volatility in the equity market in the short term, derived from tracking prices of options on the S&P 500 index, decreased by 2 percent in July. The index was down by 68 percent from its peak in October 2008, near its multi-year average.

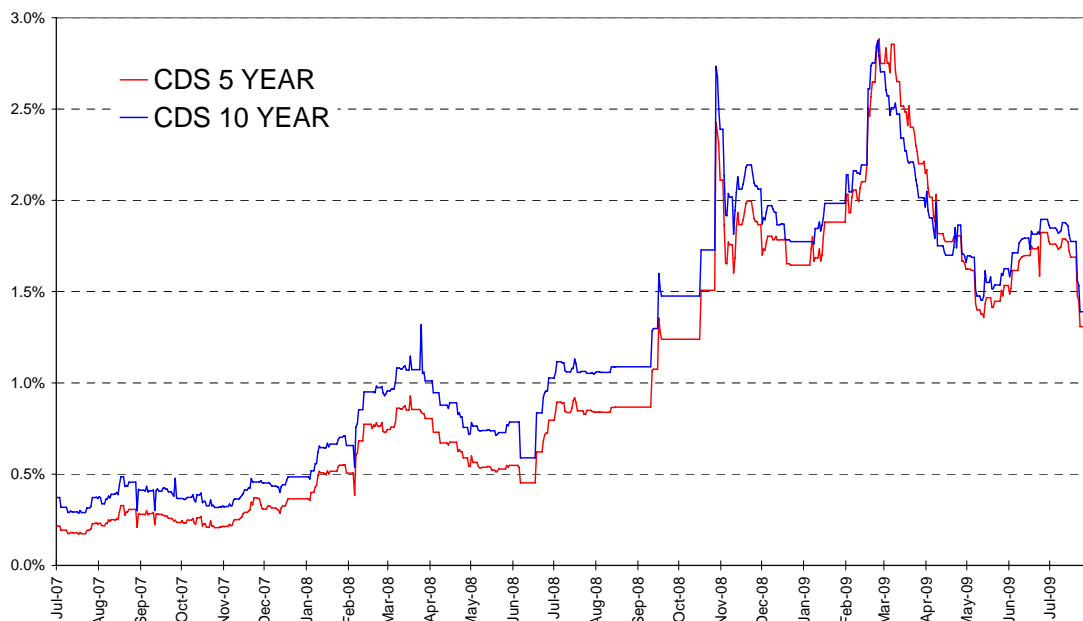
Vix Index

(Chicago Board Options Exchange Volatility Index)



Israel's risk premium, based on its CDS spread, decreased from 1.8 percent to 1.2 percent in July.

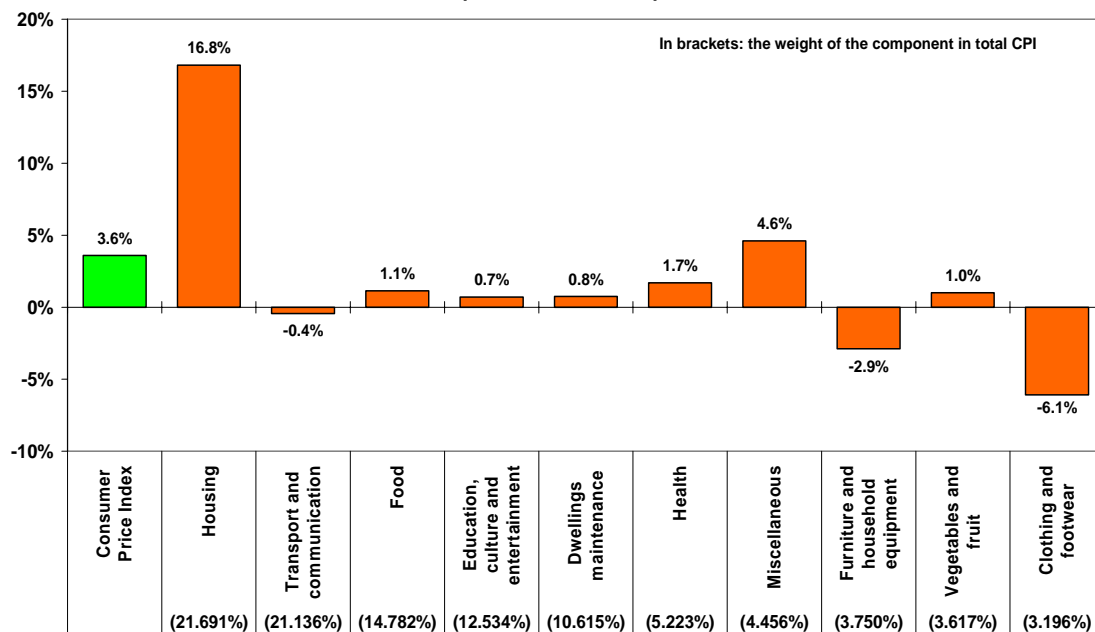
Israel's risk premium according to the CDS spread



C. Developments in Inflation and Monetary Policy

The consumer price index rose by 0.9 percent in June, far above our estimate and those of other forecasters. The housing item showed a surprising 0.5 percent increase, despite the appreciation of the shekel during the relevant period. The transportation and communications item also rose far more than expected, by 2.6 percent. Inflation in the twelve months through June reached 3.6 percent, above the upper limit of the target range; the housing item, which has gained about 17 percent in the last twelve months, is the main culprit. The next item is the "miscellaneous" item, which rose by 4.6 percent, but about half of this increase resulted from the increased taxes on cigarettes.

Changes in the CPI and its components during the last 12-months
(until June 2009)



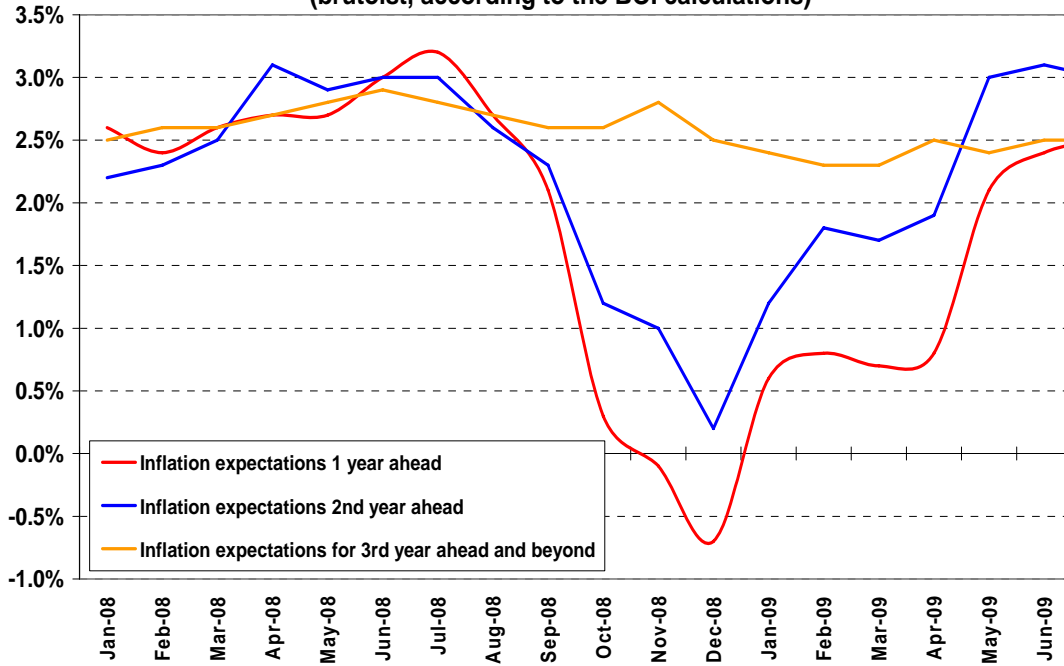
In our opinion, the pace of the increase in the housing item will weaken considerably in the coming year.

According to calculations by the BOI, inflation expectations between mid-June and mid-July were at 2.4 percent on average for the first year, 3.0 percent for the second year, and 2.5 percent for the third year and beyond, similar to the preceding month, but much higher (for the first and second years) than in the previous months.

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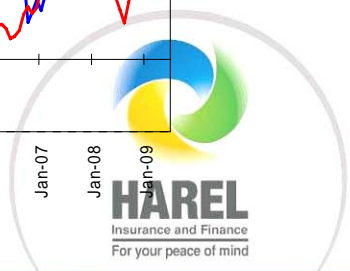
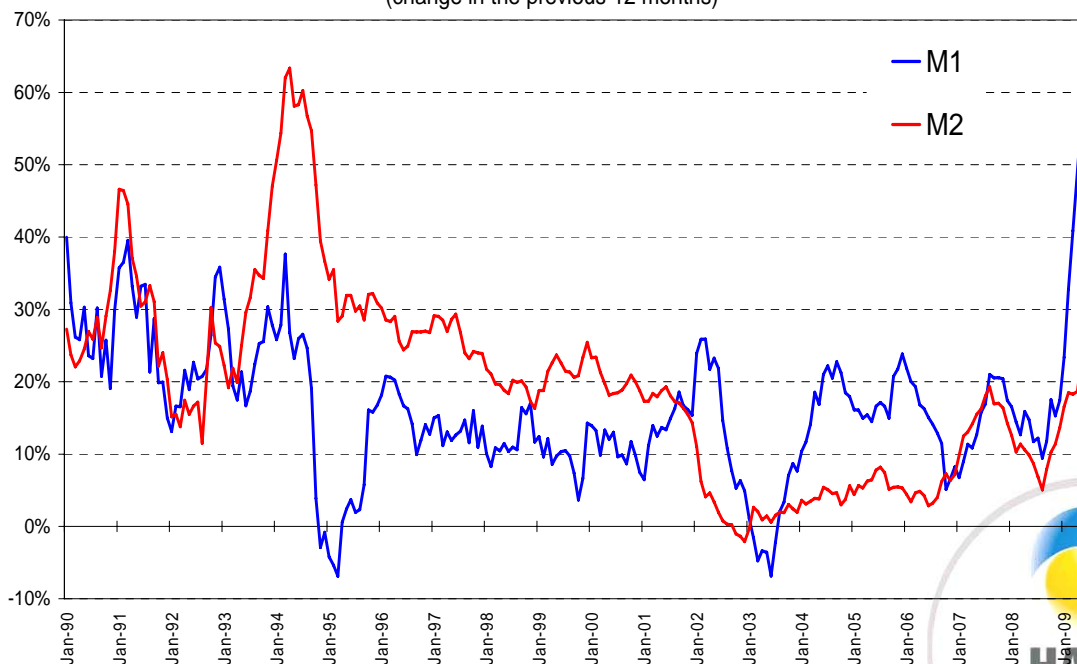


Inflation expectations derived by the capital market (brutoist, according to the BOI calculations)



The quantity of means of payment has continued to expand, though at a slower pace compared to previous months. Means of payment grew by 56.5 percent in the last twelve months, a record of many years.

Money Aggregator (change in the previous 12 months)



The Bank of Israel interest rate will remain unchanged at 0.5 percent, as expected. The BOI will end its government-bond purchasing program on August 5, while continuing its daily purchases in the foreign-currency market. The BOI also announced that it does not intend to sell the acquired bonds.

In our opinion, the BOI is likely to announce a reduction of the amount of foreign currency purchased daily in the near future. The BOI is also expected to begin raising the interest rate in one of the coming months, probably before the end of this year. The termination of government-bond purchases was to be expected, although the BOI is attempting to depict it as a success

In our view, the purchases of government bonds accomplished no objective in the near term, but could create severe problems in the area of the political economy (the relationship between the BOI and the government) in the longer term; the BOI will find it difficult to sell the acquired bonds before their maturity dates, and even then it may face government pressures to “roll over” its holdings due to the government’s need to finance high deficits in the coming years as well.

The BOI's Inflation Report states, *"Inflation expectations for the coming year rose during the second quarter... It is likely that the increase in indirect taxes and water prices, which is expected to affect prices in the third quarter, and the increase in prices of commodities and oil during the second quarter contributed to this development. A relatively large increase in prices is therefore possible in the coming few months, to be reflected in an increase in the annual rate of inflation (in a measurement over the preceding twelve months). Later this year inflation is expected to moderate, due to the ongoing recession in domestic and global demand and the weakness in the labor market, which is expected to persist at least for some time to come."* We agree with these assessments in principle, but in our opinion the forecast of the central model used by the BOI, in which inflation will reach 1.6 percent over the next twelve months, is too low.



D. Developments in the Global Economy

The International Monetary Fund has updated its forecasts for global growth. The estimate for **global growth in 2010** now stands at 2.5 percent, up 0.6 percentage point from the previous forecast released in April. The forecast for 2009 remains almost unchanged, at a negative 1.4 percent, versus negative 1.3 percent in the previous estimate.

The forecast for the **United States** and the developing countries was adjusted upward. The growth forecast for the US has risen to 0.8 percent in 2010, from 0 in the previous estimate. The forecast for growth in the **developing countries and emerging markets** increased to 4.7 percent, from 4.0 percent in the previous estimate; the forecast for **China** was revised upward by 1.0 percentage point, to 8.5 percent. By contrast, growth forecasts for some of the developed countries were adjusted downward. The growth forecast for the **euro zone** in 2010 remains almost unchanged at a negative 0.3 percent.

World Economic Outlook Update Projections (annual percent change)

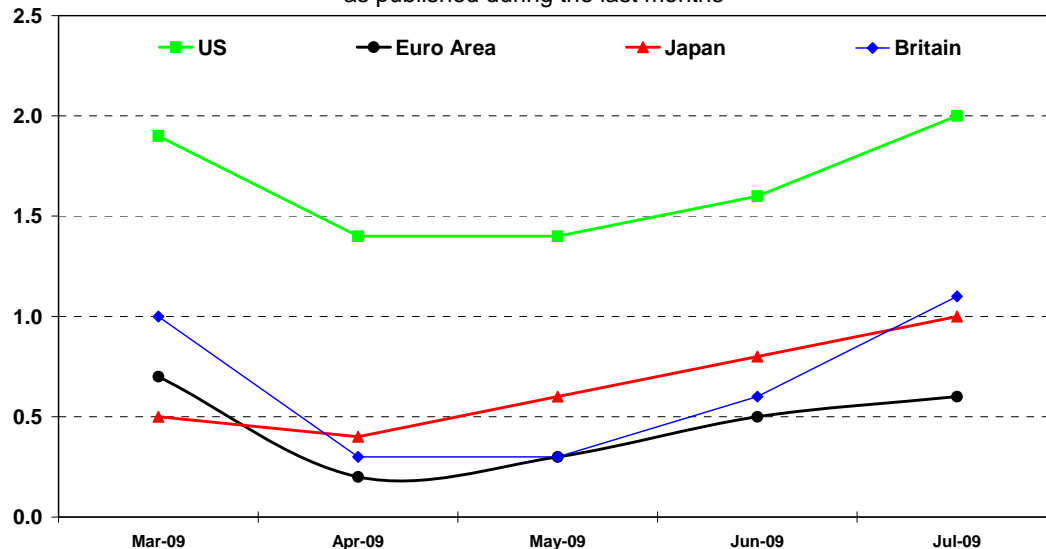
	2007	2008	2009	Previous est.	2010	Previous est.
World growth	5.3	3.1	-1.4	-1.3	2.5	1.9
Advanced economies	2.7	0.8	-3.8	-3.8	0.6	0.0
United states	2.0	1.1	-2.6	-2.8	0.8	0.0
Euro zone	2.7	0.8	-4.8	-4.2	-0.3	-0.4
Japan	2.3	-0.7	-6.0	-6.2	1.7	0.5
United kingdom	2.6	0.7	-4.2	-4.1	0.2	-0.4
Canada	2.5	0.4	-2.3	-2.5	1.6	1.2
Developing economies and emerging markets	8.3	6.0	1.5	1.6	4.7	4.0
Africa	6.2	5.2	1.8	2.0	4.1	3.9
Central and Eastern Europe	5.4	3.0	-5.0	-3.7	1.0	0.8
Russia	8.1	5.6	-6.5	-6.0	1.5	0.5
Developing Asia economies	10.6	7.6	5.5	4.8	7.0	6.1
China	13.0	9.0	7.5	6.5	8.5	7.5
India	9.3	7.3	5.4	4.5	6.5	5.6
Middle east	6.3	5.2	2.0	2.5	3.7	3.5
South and central America	5.7	4.2	-2.6	-1.5	2.3	1.6
Brazil	5.7	5.1	-1.3	-1.3	2.5	2.2
Mexico	3.3	1.3	-7.3	-3.7	3.0	2.1

According to the IMF, the financial markets have shown better-than-expected recovery, mainly thanks to government intervention; recent data point to moderation of the rate of the slowdown, though with wide variance among different regions globally. Despite the positive signs, the global recession is still far from over, and recovery is still expected to be slow.

The *Economist* has published its **monthly Consensus Forecast** of growth rates in the advanced countries. Forecasts for 2010 rose again, and are more optimistic than the IMF's estimates with regard to growth in the US and the UK.

Growth Forecasts for 2010

as published during the last months



Source: The Economist, Consensus Forecast

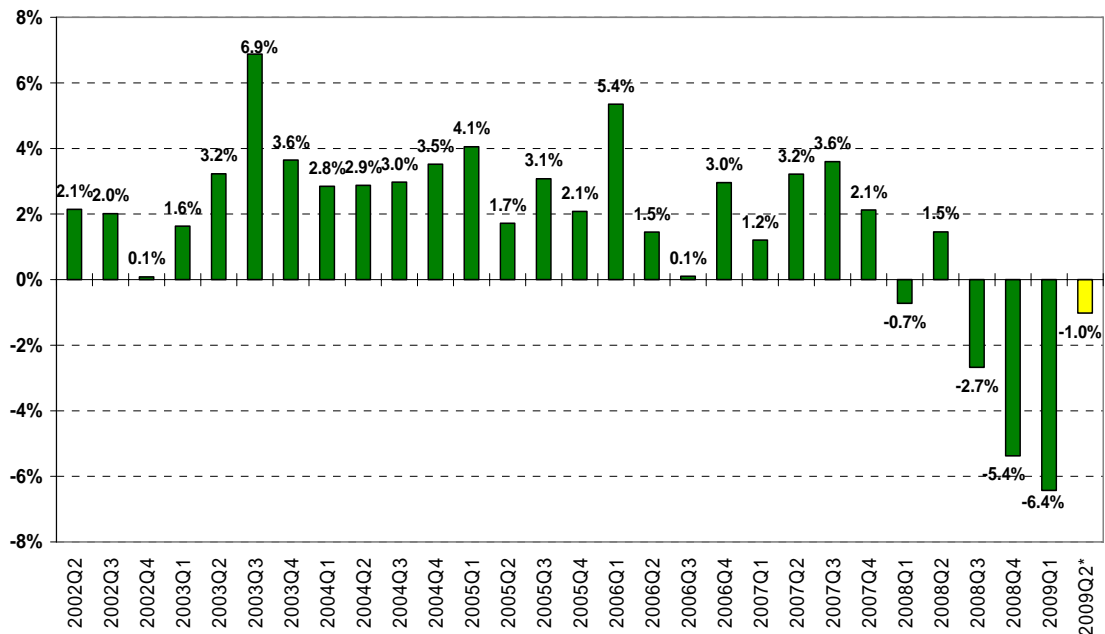
United States

According to an advance estimate, **GDP** contracted at an annualized rate of only 1.0 percent in the second quarter of 2009, a milder decline than expected. However, the composition of growth was not favorable: private consumption decreased by 1.2 percent, private investments in fixed assets decreased by 13.5 percent, and exports fell by 7.0 percent. Furthermore, extensive revisions of the GDP in the United States point to an even more severe downturn over the last year.



The U.S. Economy

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

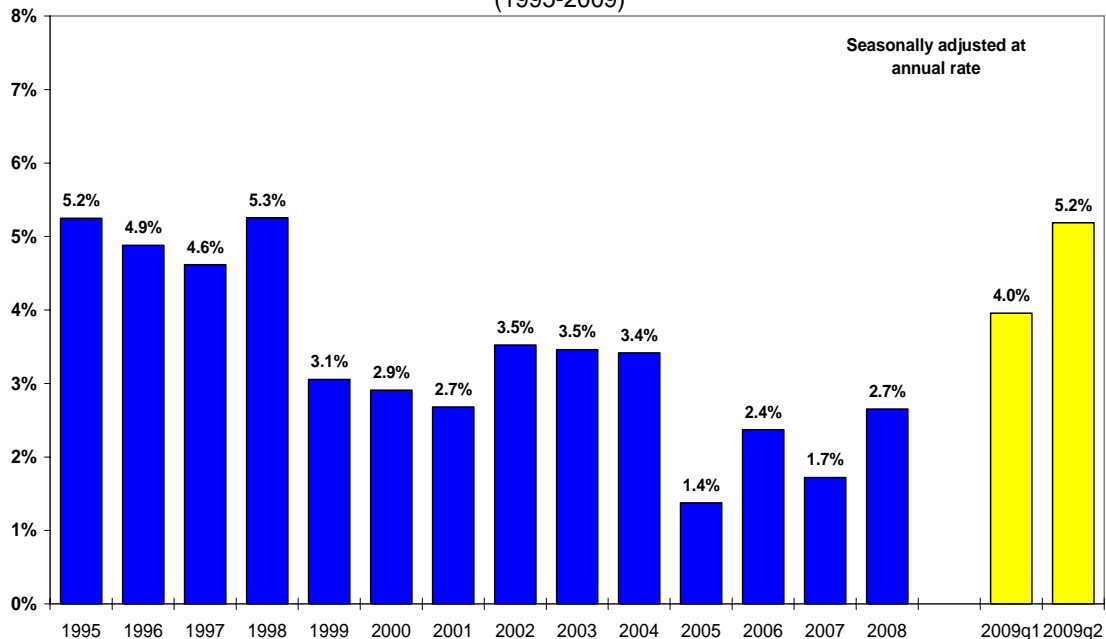


Furthermore, the national account was revised for the last 80 years. The data points to the following trends:

- For the period 1929-2008, the average growth rate was revised up by 0.1 percentage points to at 3.4 percent.
- For the period 1997-2008, the average growth rate was revised up by 0.1 percentage points to at 2.8 percent.
- The growth rate in 2009 was only 0.4 percent compared to 1.1 percent in the previous estimate.

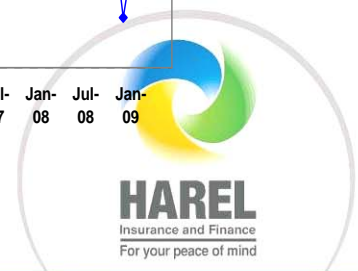
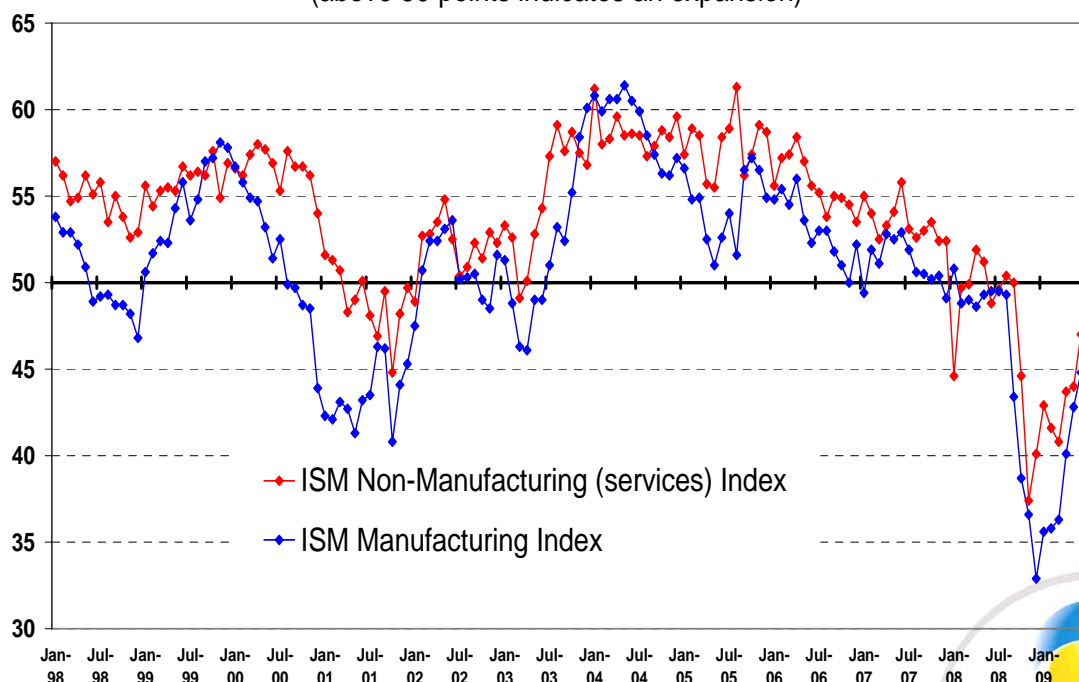
Data on the rate of savings of US households in the last decade were also adjusted upward significantly.

US - Personal saving as a percentage of disposable personal income (1995-2009)

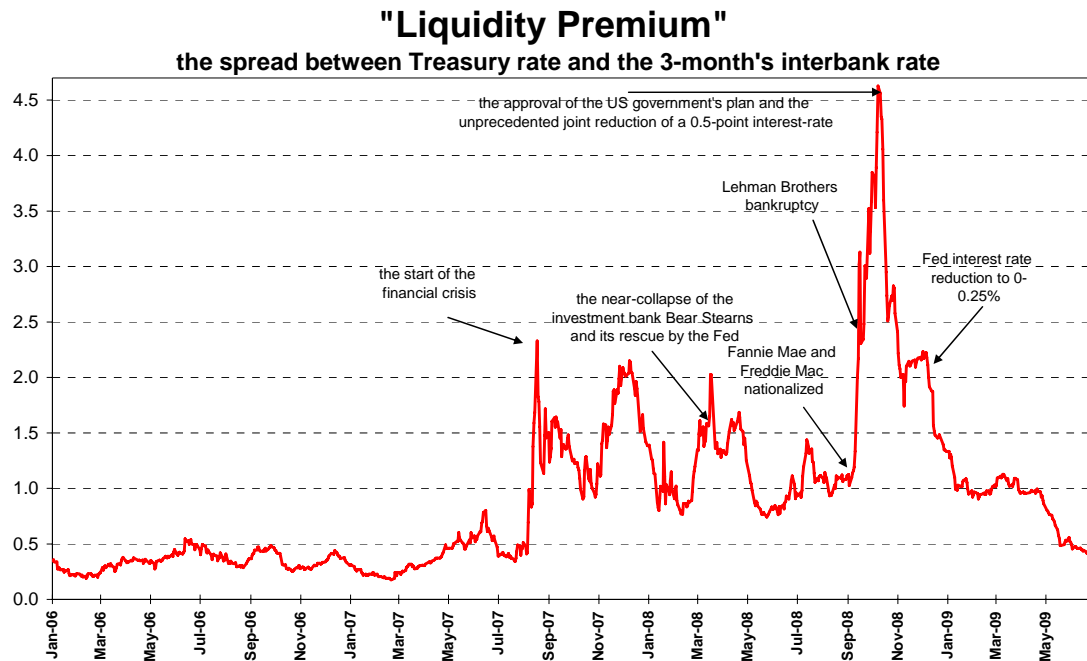


The ISM manufacturing sector index stood at 42.8 points in June, close to the expected level. The ISM service sector index was 47 points in June, above expectations.

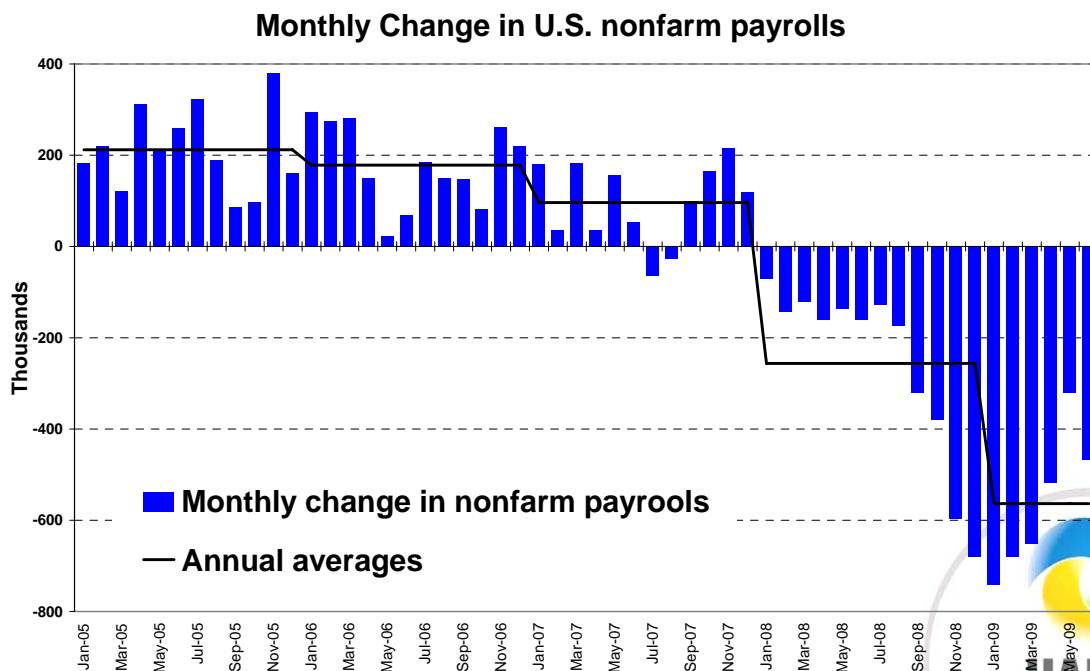
The Institute for Supply Management Index (above 50 points indicates an expansion)



The financial-system liquidity crisis was considerably tempered by the actions taken by the government and the Fed. The risk premium reflected by the gap between the interbank interest rate and the interest on three-month government bonds contracted to 0.3 percentage points.

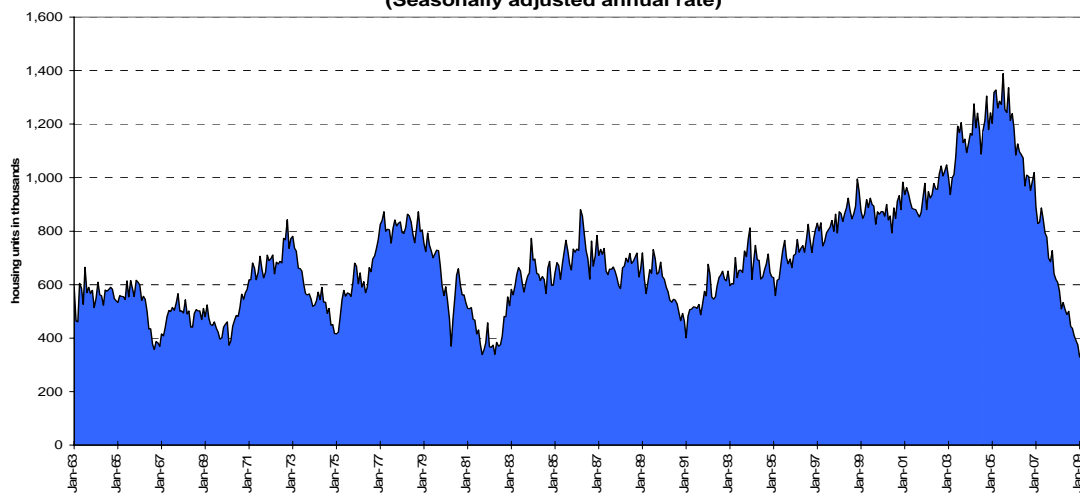


With a decrease of 470,000 jobs, the **job loss rate** was a negative surprise. The **unemployment rate** rose to 9.5 percent.



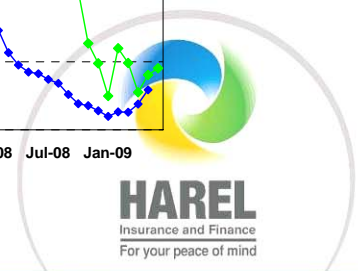
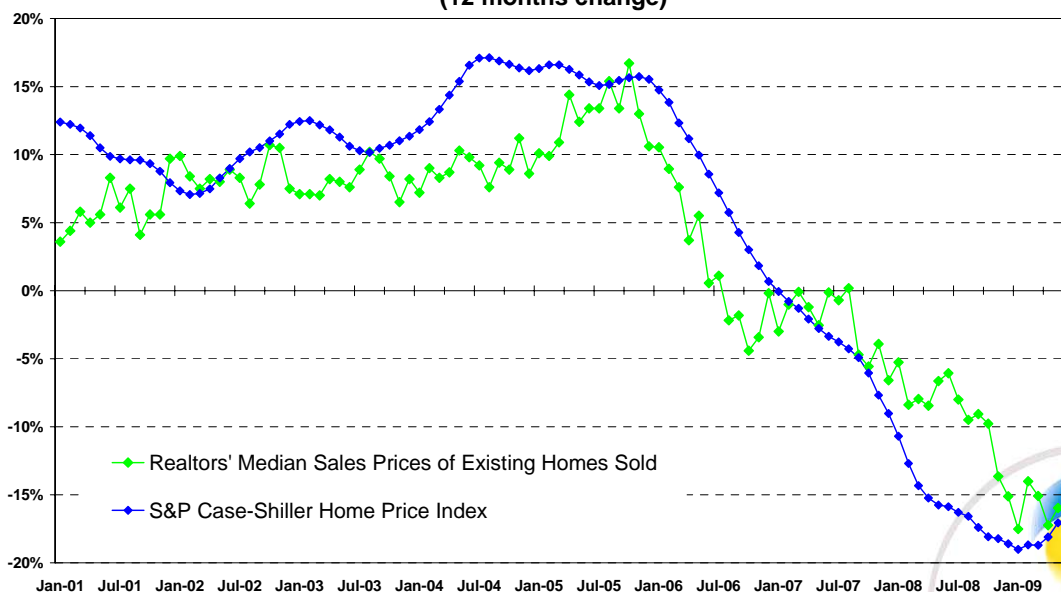
Housing-market figures for May were positive. Construction starts and permits surprisingly increased by 4 and 9 percent respectively, but remained about 50 percent lower than a year ago. Sales of existing homes increased by 3.6 percent in June, the third consecutive increase, as housing prices climbed to the highest level since last October. Sales of new homes grew by a sharper-than-expected 11 percent in June, although the current level remains the lowest since the early 1980s.

New Family Houses Sold (Seasonally adjusted annual rate)



The S&P Case-Shiller index of housing prices in twenty major US cities rose by 0.5 percent in May, for the first time since July 2006.

US Home Prices (12 months change)



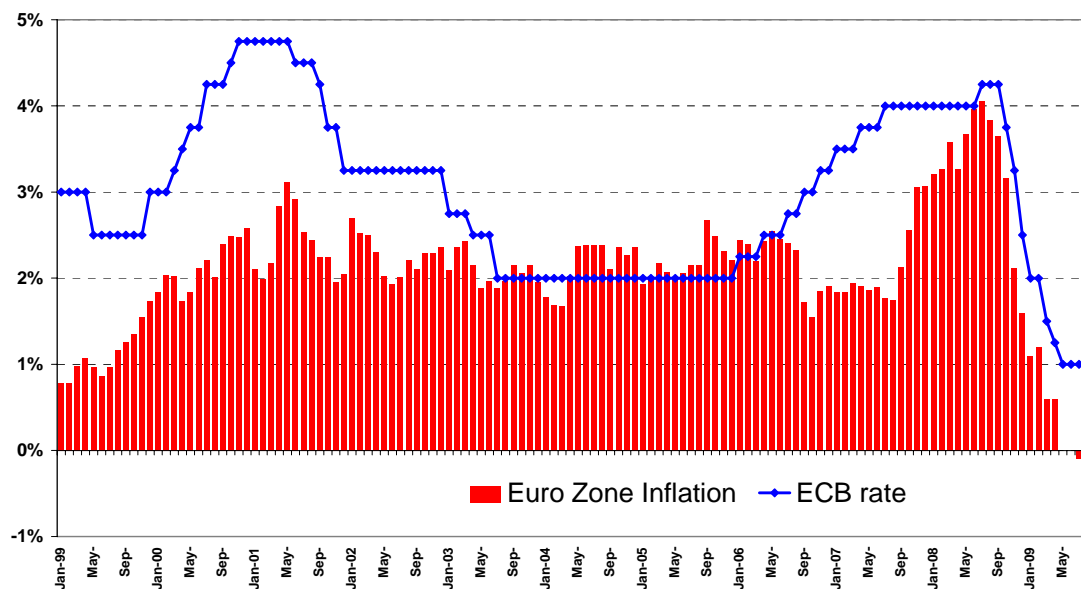
The consumer price index rose by 0.7 percent in June, in line with expectations, and inflation in the twelve months ended in June reached a negative 1.4 percent. The core index, excluding food products and energy, rose by 0.2 percent, as expected, while core inflation totaled 1.7 percent.

Euro zone

The European Central Bank left the interest rate unchanged at 1.0 percent, as expected. Other actions taken by the ECB recently, mainly loans to banks, have caused the effective short-term interest rate to be lower than the official rate. In any case, an increase in the interest rate does not appear likely in the next year in the euro zone. The governor of the central bank stated that in his opinion the apex of the economic slowdown has passed, but growth will not begin until 2010.

According to an initial estimate, inflation stood at a negative 0.6 percent in July, lower than expected.

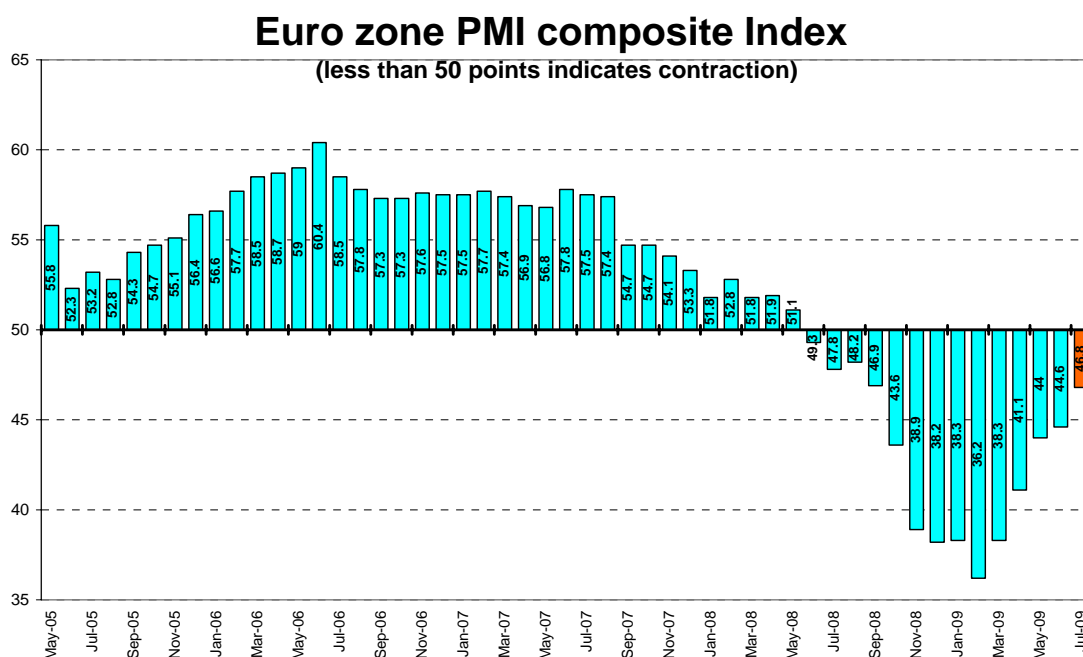
Euro Zone Inflation and ECB Interest Rate



Recent data point to improvement in economic conditions compared to the previous period; renewed demand from overseas (primarily China, India, and the US) contributed to an improvement in business sentiment.

Industrial production grew by 0.5 percent in May, but still decreased by 17 percent in the twelve months ended in May.

The euro zone purchasing managers' index reached 46.0 points in July, according to an initial estimate, above expectations. This figure indicates continued recession, at weakened intensity. The IFO index of business sentiment in Germany showed an improvement in July.

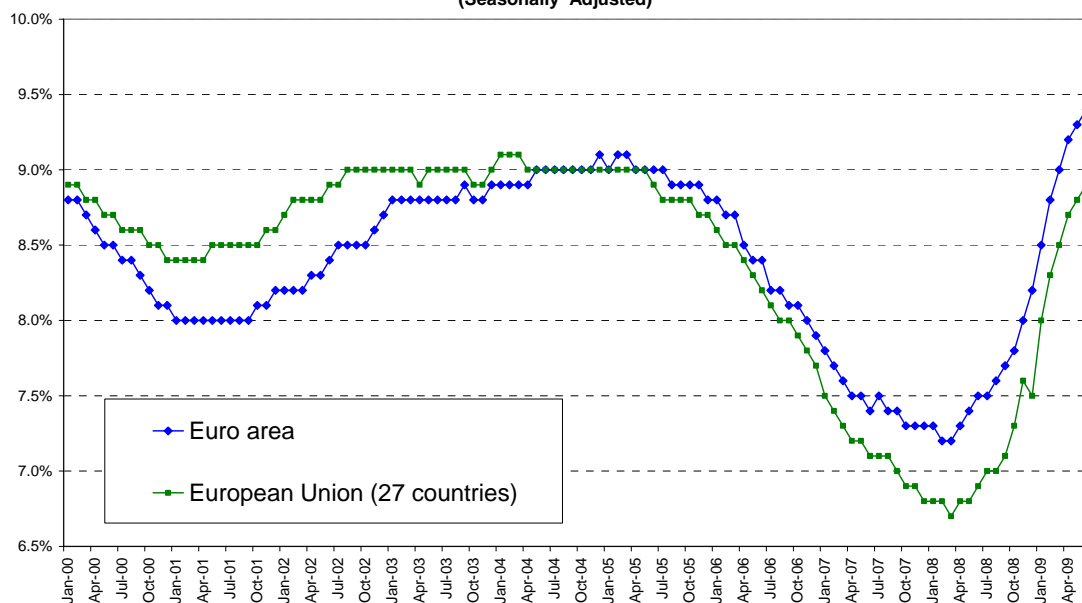


Notwithstanding the relative optimism, a return to rapid growth still appears distant. Spain and Ireland are suffering the consequences of the implosion of local real-estate bubbles, which will impede their recovery, while Italy is undergoing a decline in exports due to structural problems and the strong euro.

Unemployment in the euro zone stood at 9.4 percent in June, lower than expected, versus 7.5 percent in June 2008.

In the major euro-zone economies, unemployment in Spain is at 18 percent, compared with 7.7 percent in Germany and 9.4 percent in France. Unemployment in Germany and France, the euro zone's largest economies, increased moderately relative to the other euro-zone countries, mainly thanks to intervention and/or policies of the local governments. There are concerns that a steep increase in the unemployment rate in Germany and France may serve as a negative factor weighing down future growth.

Euro area and Eu27 Unemployment rates
(Seasonally Adjusted)



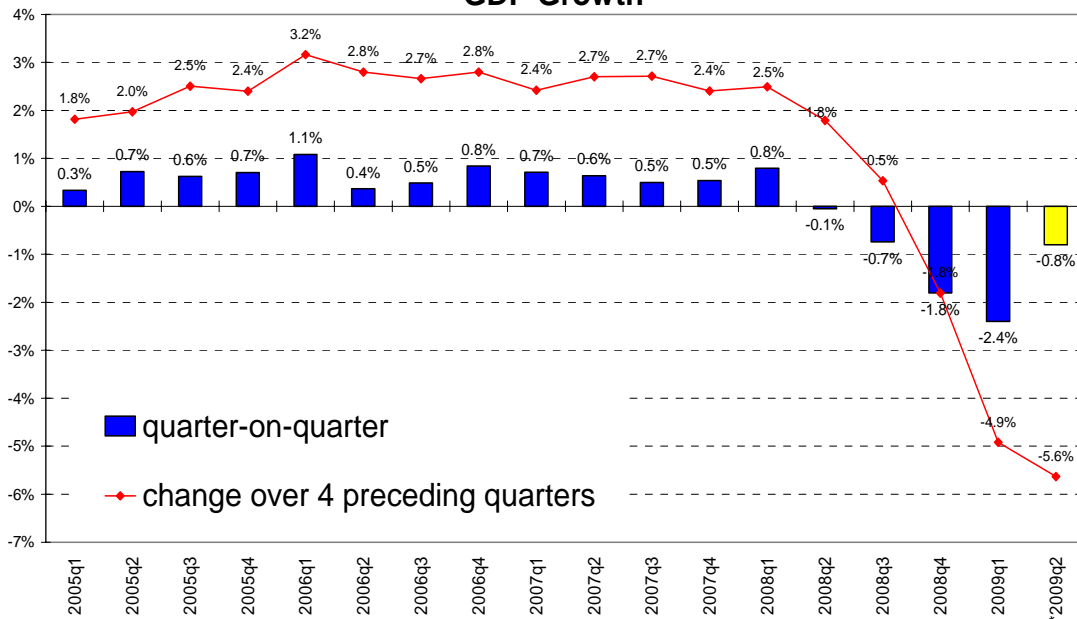
United Kingdom

The UK economy contracted by 0.8 percent in the second quarter of 2009, or an annualized rate of 3.2 percent, based on an initial estimate, a sharper decline than expected, but less steep than in the previous two quarters. The decrease stemmed from factors including the contraction in industrial output and financial services.

In addition, the first-quarter growth estimate was revised downward to a negative 2.4 percent, or negative 10 percent annualized, the sharpest decline since the late 1960s.

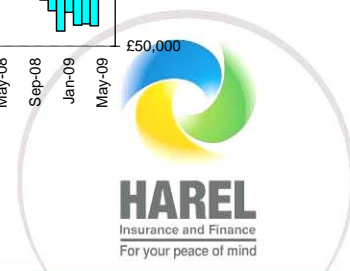
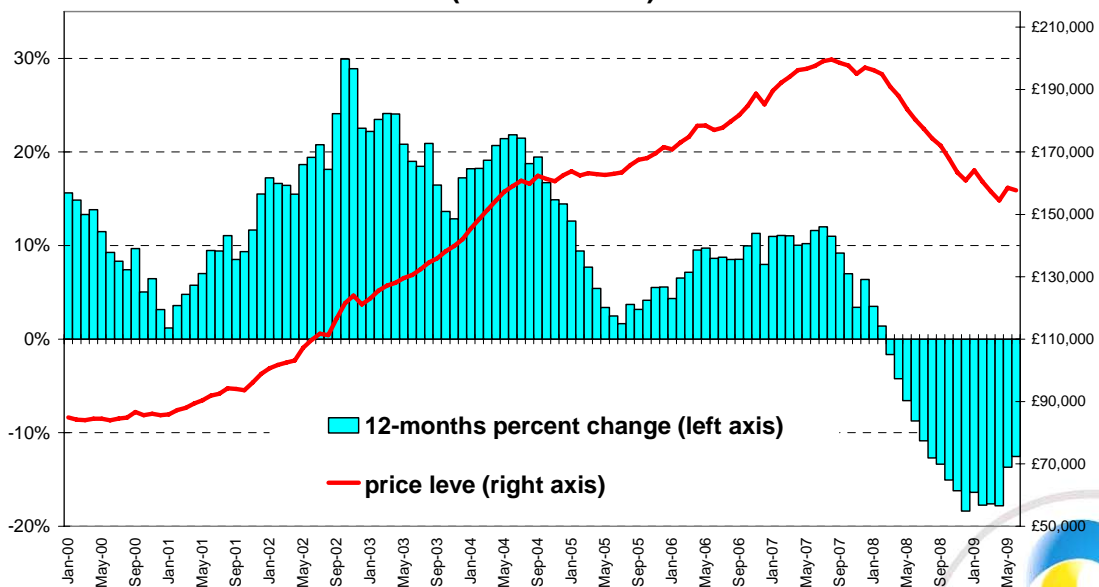


United Kingdom GDP Growth



The UK's Halifax house price index fell by 0.5 percent in June, and remains 21 percent lower than the record level of August 2007.

UK house prices (Halifax index)



Japan

The Bank of Japan's **Tankan** survey for the second quarter of 2009 indicates that Japanese companies are less pessimistic. Following continuous deterioration in the index of companies' business confidence since late 2006, the index rose for the first time, although the improvement was smaller than expected. Nonetheless, the index remains negative, meaning that the number of companies that are pessimistic about their condition exceeds the number of optimistic companies.

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Please address comments or questions to Mr. Ofer Klein at
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Important Announcements in the Coming Month

Title	date	Day	Time	Link
ISM manufacturing sector, us	3 AUG	Mon	17:00	www.ism.ws
Private income and consumption data, US	4 AUG	Tue	15:30	http://bea.gov/
PMI index, euro zone	5 AUG	Wed	11:00	http://www.markiteconomics.com/
Retail sales, euro zone	5 AUG	Wed	12:00	www.ec.europa.eu/eurostat
ISM service sector index, US	5 AUG	Wed	17:00	www.ism.ws
Average wages	6 AUG	Thu	13:00	http://www1.cbs.gov.il/reader
Interest-rate decision, UK	6 AUG	Thu	14:00	www.bankofengland.co.uk
Interest-rate decision, euro zone	6 AUG	Thu	14:45	www.ecb.int
Unemployment, us	7 AUG	Fri	15:30	www.bls.gov
Fed interest decision	12 AUG	Wed	21:15	
Foreign trade, Israel	12 AUG	Wed	13:00	http://www1.cbs.gov.il/reader
Retail sales, US	13 AUG	Thu	15:30	http://www.census.gov/svsd/www/adseries.html
Estimate 2Q growth rate, euro zone	13 AUG	Thu	12:00	www.ec.europa.eu/eurostat
CPI, euro zone	14 AUG	Fri	12:00	www.ec.europa.eu/eurostat
CPI, US	14 AUG	Fri	15:30	www.bls.gov
CPI, Israel	14 AUG	Fri	14:00	http://www1.cbs.gov.il/reader
National accounting and growth data, 2Q 2009	16 AUG	Sun	13:00	http://www1.cbs.gov.il/reader
Incoming tourists, Israel	17 AUG	Mon	13:00	http://www1.cbs.gov.il/reader
Construction starts and permits, US	18 AUG	Tue	15:30	http://www.census.gov/pub/const
Industrial production index and trade and service sectors revenue index	18 AUG	Tue	13:00	http://www1.cbs.gov.il/reader
Retail sales, UK	20 AUG	Thu	11:30	http://www.statistics.gov.uk
Sales of existing homes, US	21 AUG	Fri	17:00	http://www.realtor.org/Research.nsf/Pages/EHS_data
Interest-rate decision, BOI	24 AUG	Mon	17:30	http://www.bankisrael.gov.il/
Hotel stays	25 AUG	Tue	13:00	http://www1.cbs.gov.il/reader
New dwelling sold in private sector	25 AUG	Tue	13:00	http://www1.cbs.gov.il/reader
Sales of new homes, US	26 AUG	Wed	17:00	http://www.census.gov/const/www/newressalesindex.html
Unemployment 2Q, Israel	27 AUG	Thu	13:00	http://www1.cbs.gov.il/reader
2Q growth rate, US	27 AUG	Thu	15:30	http://bea.gov/
2Q growth rate, UK	28 AUG	Fri	11:30	http://www.statistics.gov.uk
Private income and consumption data, US	28 AUG	Fri	15:30	http://bea.gov/
Michigan University consumer confidence index	28 AUG	Fri	17:00	http://www.sca.isr.umich.edu/
CPI estimate, euro zone	31 AUG	Mon	12:00	www.ec.europa.eu/eurostat
Housing starts, Q2	31 AUG	Mon	13:00	http://www1.cbs.gov.il/reader