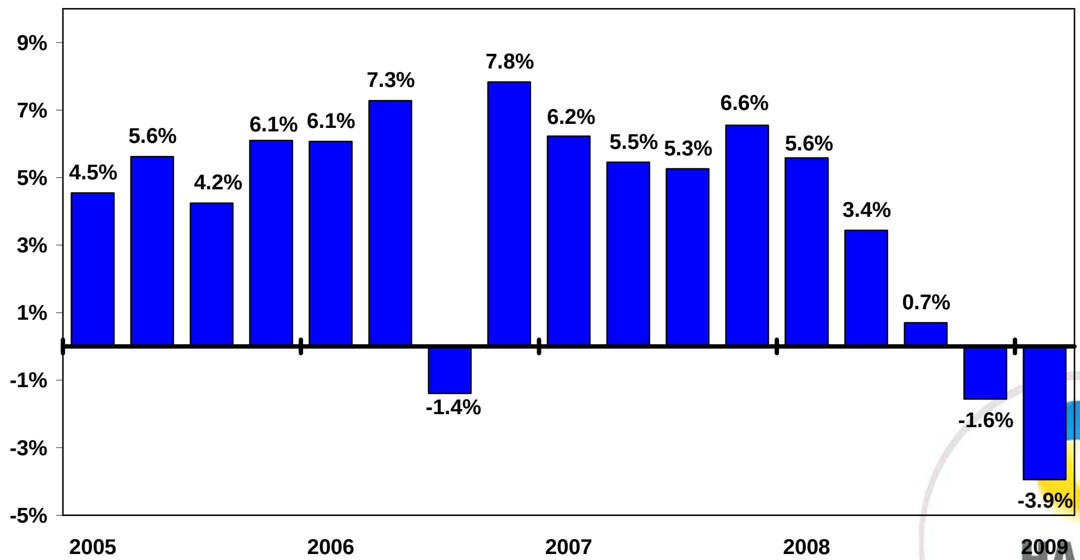
Weekly Macroeconomic Review June 23, 2009

	Expectations derived from the capital market	Our forecast
Inflation in the coming months		0.2% in June 1.1% in July
Future cumulative inflation – next 12 CPIs (through May 2010 CPI)	3.0%	3.2%
Inflation through July 2011 CPI (average annual rate)	2.8%	2.7%
Bank of Israel interest rate, 6 months ahead	1.00% (up 0.50)	0.85%
Fed interest rate, 6 months ahead	0.35% (up 0.10)	0.25%
Yield on Israeli Government 10-Year bond, 6 months ahead	5.79% (up 0.33)	5.75%
Yield on US Treasury 10-Year bond, 6 months ahead	3.93% (up 0.24)	4.10%
Dollar exchange rate, 6 months ahead	NIS 3.98 (unchanged)	NIS 4.06 (up 1.9%)

Israel

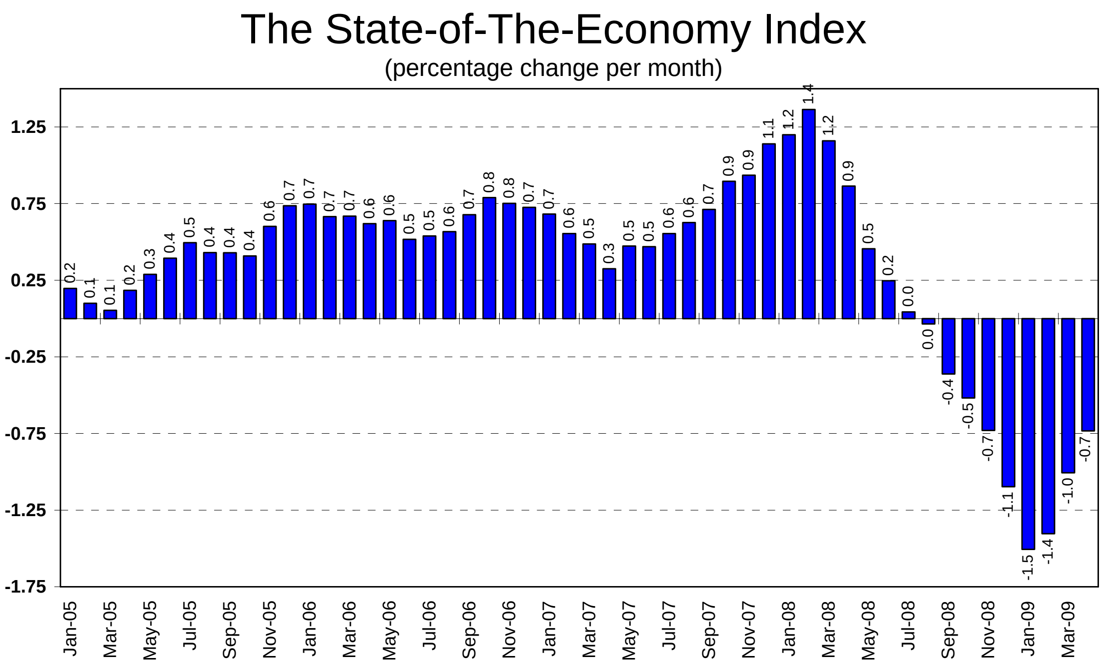
The Central Bureau of Statistics has issued a downward revision of **growth rates** in the last three quarters.

GDP Growth
(quarter-on-quarter at annual rate)



Real GDP in the first quarter of 2009 was 0.5 percent lower than in the initial estimate a month ago, but **nominal GDP** was 3.6 percent higher than the initial estimate; in other words, **GDP prices** were steeply adjusted upward.

The industrial production index decreased by 1 percent in April and by 11 percent in the twelve months ended in April. The **trade and service sectors revenue index** decreased by 3 percent in April and 10 percent in the twelve months ended in April. The **Bank of Israel's composite index** for May decreased by 0.5 percent, and data for the last two months were adjusted downward. According to these data, it appears that GDP will decrease considerably in the **second quarter of 2009** as well.

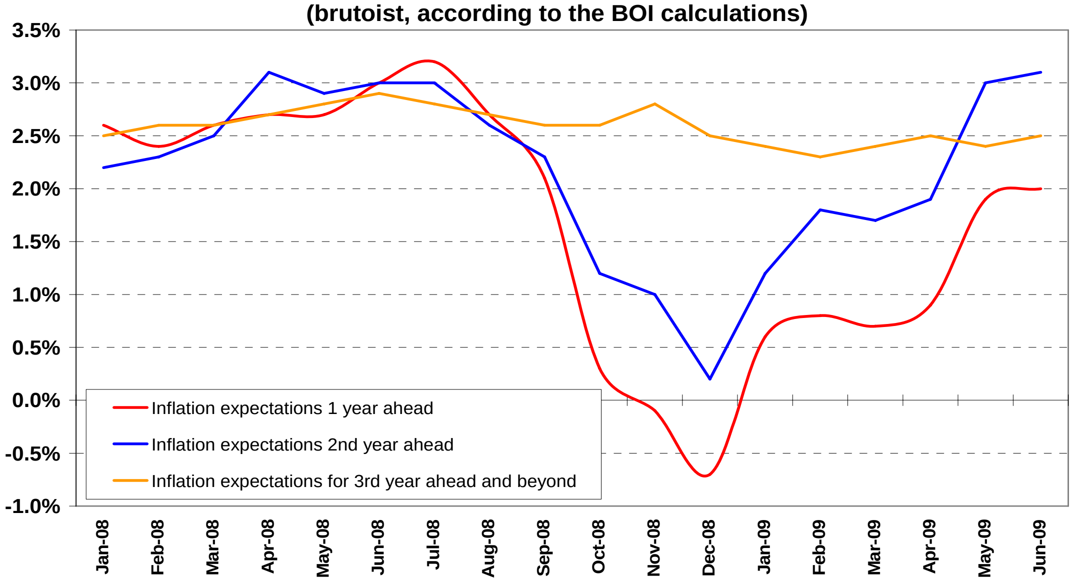


The BOI decided to maintain the interest rate at 0.5 percent, as expected. The BOI's announcement contained no major news relative to last month.

According to calculations by the BOI, **inflation expectations** between mid-May and mid-June were at 1.9 percent on average for the first year, 3.1 percent for the second year, and 2.5 percent from the third year forward, similar to the average in May, but much higher than in the preceding months.

Inflation expectations derived by the capital market

(brutoist, according to the BOI calculations)



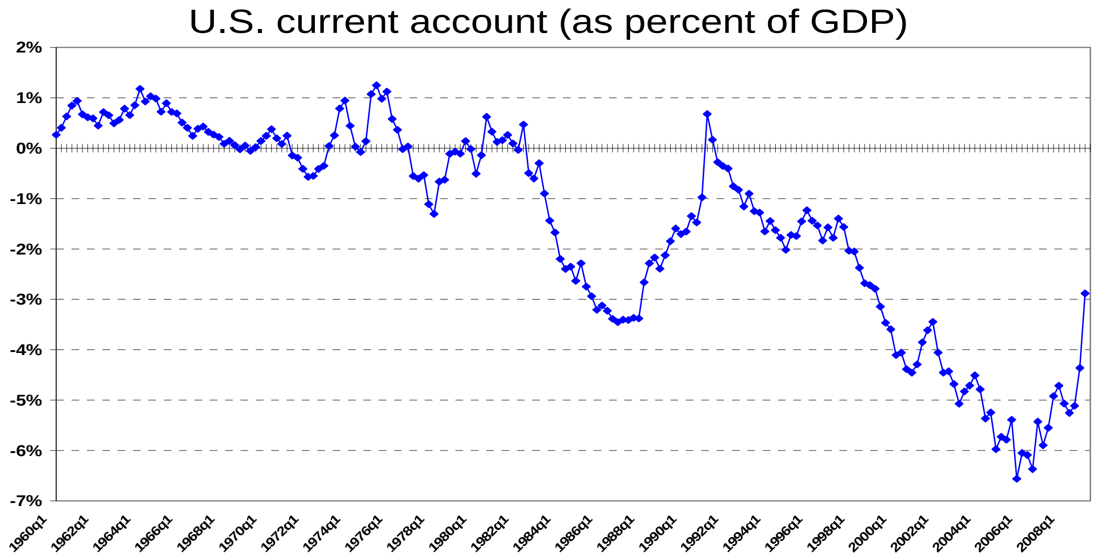
The quantity of means of payment continued to grow, though at a lower rate than in the previous months, rising by 2.6 percent in May and by 54.5 percent in the twelve months ended in May.

We have adjusted **our inflation forecast** for the coming months upward, assuming that both the VAT hike and the increase in water prices will take effect on July 1, the purchase tax on cars will rise on August 1, and taxation of fruits and vegetables will begin on January 1 (if VAT is not applied to fruits and vegetables after all, general VAT may rise by an additional 0.5 percentage point, with similar effects on the CPI). The inflation forecast looks high, but it should be noted that a considerable part of the expected price gains derive from one-time or temporary increases in taxes, so that prices will take a step down once the period of higher tax rates is over; for example, the water tariff and possibly the VAT rate may be lowered in the future).

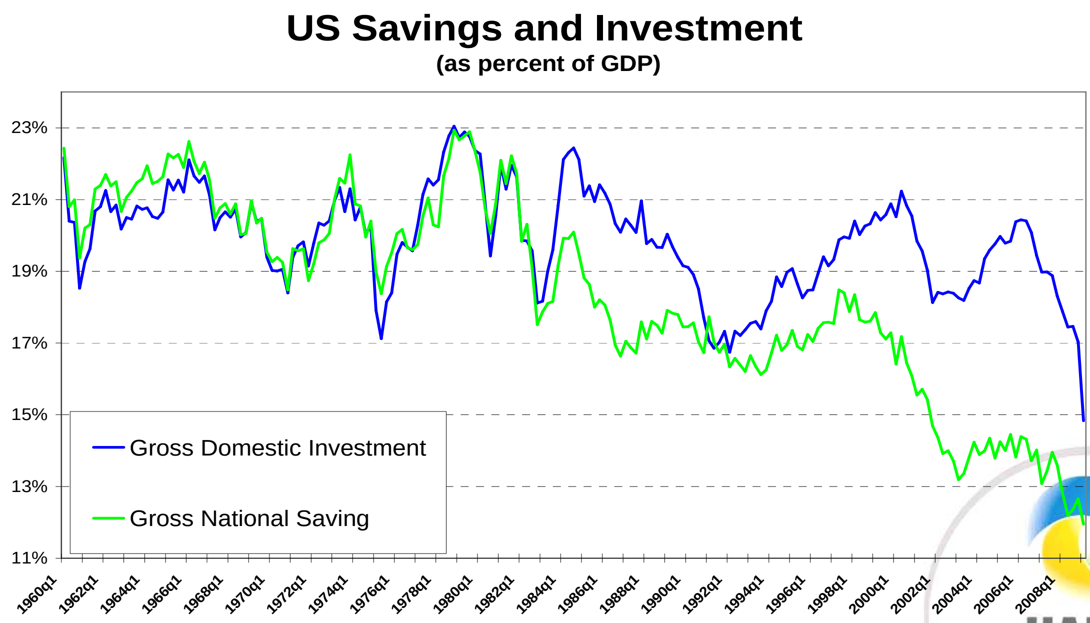
Implied inflation in the bond market for the twelve months through May 2010 is similar to our forecast. However, the market expectation for the following years, at about 2.8 percent for each additional year, appears to be too high; in our opinion, unlinked bonds are therefore preferable to linked bonds, except for the first year.

United States

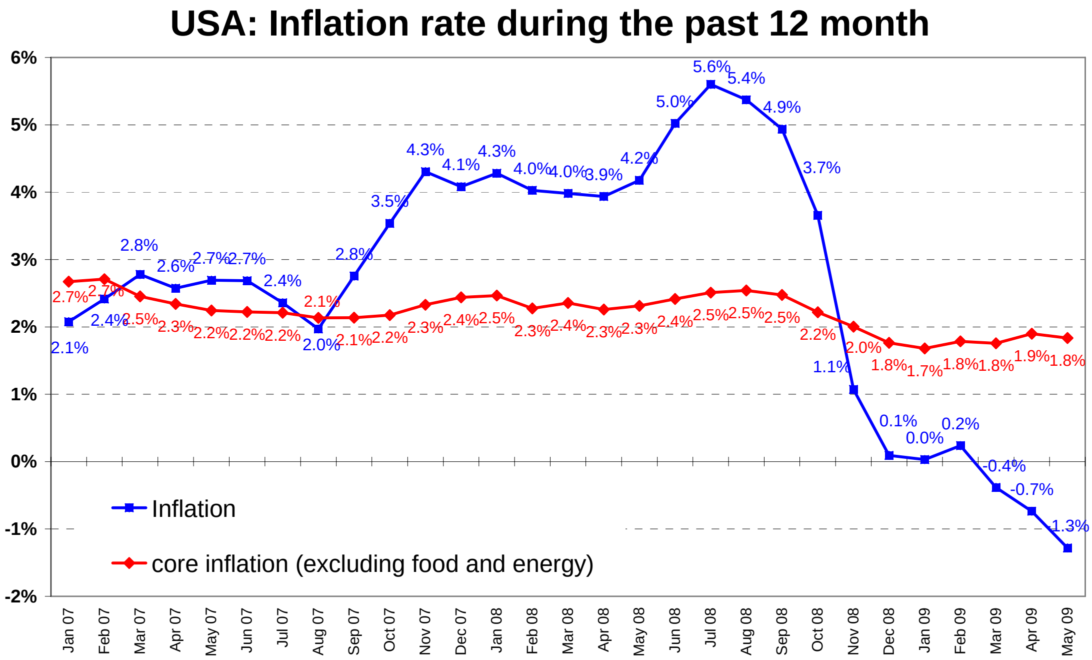
The deficit in the current account of the balance of payments contracted greatly in the first quarter of 2009, to 2.9 percent of GDP, as a result of a sharp decline in exports.



However, the improvement in the current account does not reflect an increase in **national savings in the US**, but an ongoing decline in **investments in the American economy**. Thus, the deficit is expected to expand again in the future, as the economy begins to recover from the recession, and investments as a percentage of GDP will increase.



The consumer price index rose by 0.1 percent in May, and **inflation** in the last twelve months reached negative 1.3 percent, less than expected. The **core index**, excluding food products and energy, rose by 0.1 percent, as expected, while core inflation totaled 1.8 percent.



Housing-market figures published for May were better than expected. **Construction starts** grew by 17 percent, and the number of **construction permits** rose by 4 percent. However, these figures are still 45 percent lower than twelve months ago.

Important Announcements in the Coming Week

- Data on sales of existing homes will be published in the US on Tuesday, June 23.
- Data on sales of new homes will be published, and the Fed's interest-rate decision will be announced, on Wednesday, June 24.
- Data on private income and consumption in the US and the University of Michigan's consumer confidence index will be published on Friday, June 26.

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

and at www.harel-finance.co.il/macro/ENG in English.

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