bank hapoalim
financial division

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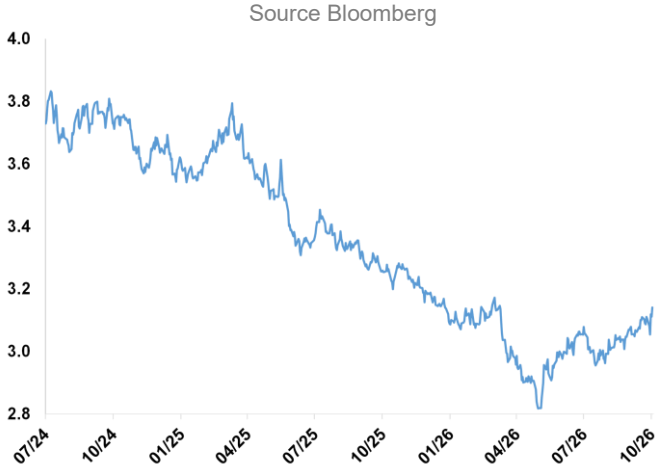
Elections are behind Israel, coming soon in the US

- **From the markets' perspective, the lack of a clear outcome in the elections is a risk scenario that has materialized. Without a permanent and stable government, it will be difficult to implement unpopular policies, such as fiscal adjustments, reforms, and the promotion of long-term investment.**
- **The large surplus in the current account of the balance of payments turned into a small deficit in the first two quarters of the year. It is difficult to determine whether this is a temporary development resulting from the war, or a structural factor in the economy, reflecting a high government deficit, increased defense imports, and possibly changes in private savings and domestic investment. In any case, this makes the shekel more vulnerable to external developments, such as global equity volatility and geopolitical events.**
- **Inflation is expected to respond to the exchange rate, and markets no longer expect interest rates to decline.**
- **The derivatives market currently reflects inflation of 1.9% over the coming year. We expect higher inflation of 2.3% over the next 12 months.**
- **The decline in long-term yields globally has bypassed Israel. The 10-year yield has remained at around 4.2%, while in the US it has declined by approximately 30 basis points in recent weeks.**

The elections are behind us, but it is still difficult to see a government being formed, and political uncertainty is likely to remain elevated in the coming weeks. The possibility of an escalation with Iran following the US mid-terms was also back on the agenda this week, following Trump's remarks that this option remains open after the elections. The shekel reacted to these developments, weakening by approximately 2% against the dollar since election day. The Tel Aviv 125 index declined by 4.2%, with domestically oriented sectors such as real estate and financials declining sharply. **From the markets' perspective, the lack of a clear outcome in the elections is a risk scenario that has materialized. Without a permanent and stable government, it will be difficult to implement unpopular policies, such as fiscal adjustments, reforms, and the promotion of long-term investment**. This scenario already occurred in Israel: between April 2019 and March 2021. The country held five rounds of elections, and even the government formed in March 2021 lasted only about a year and a half. During most of this period, the economy operated under a continuation budget (based on the last approved budget), including during the COVID crisis, when exceptional emergency expenditures were approved. On the one hand, this is encouraging, as the economy performed reasonably well during this period. On the other hand, the situation today is different: the increase in defense spending is unlike the temporary expenditures during COVID, the debt level is higher, and interest rates (financing costs) are also higher.

What caused the recent shekel weakness? Since the end of May, the shekel has depreciated by approximately 12% against the dollar. This can be explained by political uncertainty, but it is also possible that the fundamental factors that supported the shekel in the past have weakened. **The large surplus in the current account of the balance of payments turned into a small deficit in the first two quarters of the year. It is difficult to determine whether this is a temporary development resulting from the war, or a structural factor in the economy, reflecting a high government deficit, increased defense imports, and possibly changes in private savings and domestic investment. In any case, this makes the shekel more**

What is behind the shekel's change in direction?
Daily exchange rates, USD/ILS.
Source Bloomberg



vulnerable to external developments, such as global equity volatility and geopolitical events.

Inflation is expected to respond to the exchange rate, and markets no longer expect interest rates to decline. The market is not pricing in the possibility of even one rate hike over the next year. Assuming the exchange rate stabilizes at its current level, we are likely to start seeing an impact on inflation in the coming months, with inflation accelerating early next year. The Ministry of Finance has decided to reduce the excise tax discount by half a shekel, meaning that fuel prices, which declined temporarily at the beginning of the month, will push higher. A discount of half a shekel on the excise tax still remains, and is also expected to be eliminated later on. **The derivatives market currently reflects inflation of 1.9% over the coming year. We expect higher inflation of 2.3% over the next 12 months.**

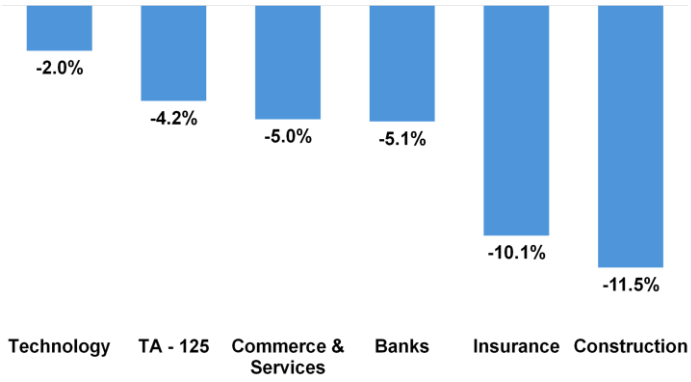
It is difficult to envisage an interest rate cut in the near future. In fact, the probability of a rate hike is higher than that of a rate cut. In light of political uncertainty and the weakening of the shekel, the Bank of Israel is likely to wait until the situation clarifies; especially as the current interest rate level does not reflect a restrictive monetary policy. Expectations of rate hikes globally have moderated somewhat over the past two weeks, following the decline in AI-related share prices, but markets still expect interest rates to rise this year in the US and Europe. By the time the political picture in Israel stabilizes, inflation will already have had time to respond to recent shekel depreciation while interest rates abroad will push higher. It is therefore difficult to envision interest rates declining in the near future.

The decline in long-term yields globally has bypassed Israel. The 10-year yield has remained at around 4.2%, while in the US it has declined by approximately 30 basis points in recent weeks. We have not witnessed any widening of spreads in Israel's dollar-denominated government bonds, suggesting that the change in the yield differential between the shekel and the dollar reflects less confidence among investors in a scenario of sustained shekel appreciation.

Stocks dependent on the domestic economy reacted to the lack of a decisive election

Changes in Equity Indices Since the Election Eve

Source: Terminal



BOI Rate and CPI Forecast			
BOI Rate		**CPI**	
December 2026	3.25%	Oct 2026	0.2%
12M Forecast	3.25%	Nov 2026	-0.1%
December 2027	3.25%	12M Forecast	2.3%

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