

November 24, 2024

It is darkest before the dawn

- **Markets are pricing in a high probability of an agreement in Lebanon, which would significantly reduce geopolitical risks.**
- **It is darkness before the dawn. Precisely when annual inflation will peak following the publication of January's CPI, it is reasonable to assume that we will also witness a sharp decline in inflation expectations to a level close to the midpoint of the inflation target.**
- **Despite the relatively strong growth in the third quarter, we expect that the data for the fourth quarter will be worse, in light of the intensification of the war in Lebanon in October and its implications for the residents of the North**

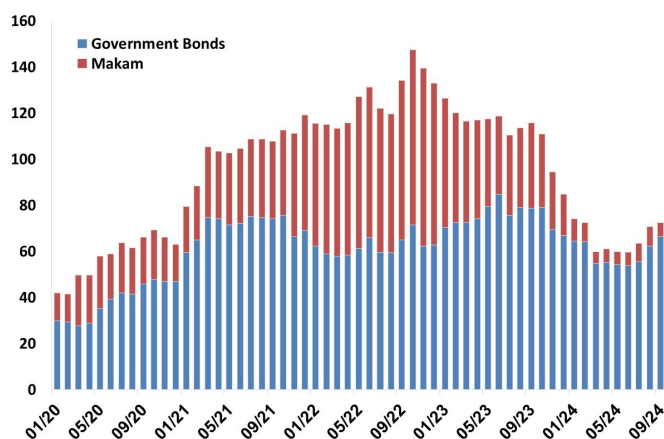
Amos Hochstein, the US administration's envoy to the region, seems to be influencing the markets in recent weeks more than any economic data or official policy statement **Markets are pricing in a high probability of an agreement in Lebanon, which would significantly reduce geopolitical risks.** This is reflected first and foremost in the exchange rate of the shekel: Since the beginning of October, the shekel has strengthened by

3.6 percent against the basket of currencies, and in fact, the shekel has strengthened since the beginning of the war. Israel's sovereign risk premium declined to about 140 basis points based on bond yield differentials, after reaching a level of about 200 basis points in September; and even foreign investors increased slightly their exposure to Israeli bonds in August and September. All this occurred while the fighting in the North continues, and an arrest warrant was issued by the International Criminal Court in The Hague against the Prime Minister and former defense minister.

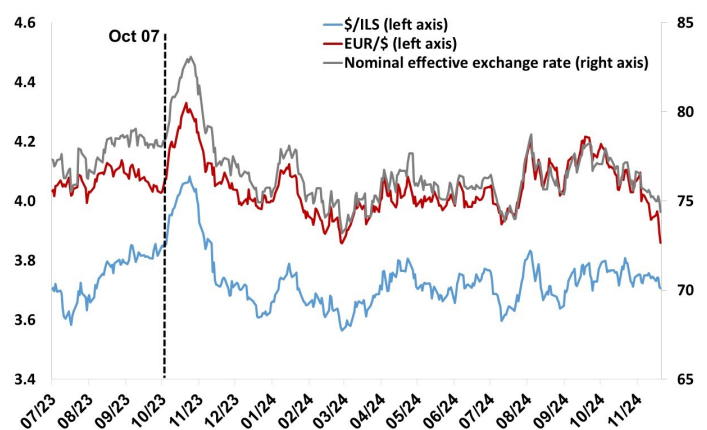
Are foreign investors' front running? Foreign investors increased their holdings in Israeli government bonds in August and September by about ILS 11 billion; and even if we subtract their reduction in Makam holdings during those two months, this is still a positive trend reversal which expresses confidence in the economy, and in retrospect also appears to be a strategy that has often paid off in the past from the perspective of foreign investors.

Is this good news already priced in the market or is there still room for further upside? If we assume that the "wisdom of the masses" reflected in the markets is correct, and that a ceasefire in the North is approaching, this will greatly reduce the geopolitical risks, and will

Foreigners increased their holdings of government bonds
Foreign investors holdings in Israeli government bonds, ILS billion, Source: BOI



Optimism regarding reaching a ceasefire in the North
Daily exchange rates
Source: Bloomberg



probably have a positive impact on other fronts and on the fiscal situation as well. This will reduce the likelihood of further reductions in Israel's credit rating, and will probably be reflected in further reduction in the sovereign risk premium, relying on S&P's credit rating, which stands at a level of "A" with a negative outlook. In the domestic shekel bond market, the picture is slightly more complicated, because the budget deficit will remain elevated for the coming years, and yield differentials between shekel bonds and US government bonds have already narrowed to less than 20 basis points for a ten-year duration. In the short term, this is where monetary policy comes in. We believe that there may be an early rate cut, and perhaps even more than one during 2025, while the markets are reflecting either rate stability or one rate cut at most.

It is darkest before the dawn. Precisely when annual inflation will peak following the publication of January's CPI due to the impact of tax increases and price adjustments in public transportation, water, and municipal taxes, it is likely that we will see a sharp reduction in inflation expectations to a level close to the midpoint of the inflation target. Inflationary risks will be balanced, and policy rates in the US will be similar to or lower than those in Israel. Under these conditions, a rate reduction will be back on the agenda,

even if annual inflation is still elevated.

The Purchasing Managers Index (PMI) for October declined sharply by 6.7 points to 44.3 points. The level of the index is the lowest it has been in the past two years and indicates a contraction in industrial activity. The economy is struggling to reach its growth potential as long as the war continues and the shortage of workers is acute **Despite the relatively strong growth in the third quarter, we expect that the data for the fourth quarter will be worse, in light of the intensification of the war in Lebanon in October and its implications for the residents of the North.**

BOI Rate and CPI Forecast			
BOI Rate		CPI	
December 2024	4.50%	Nov 2024	-0.2%
12M Forecast	4.00%	Dec 2024	0.1%
		12M Forecast	2.9%

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