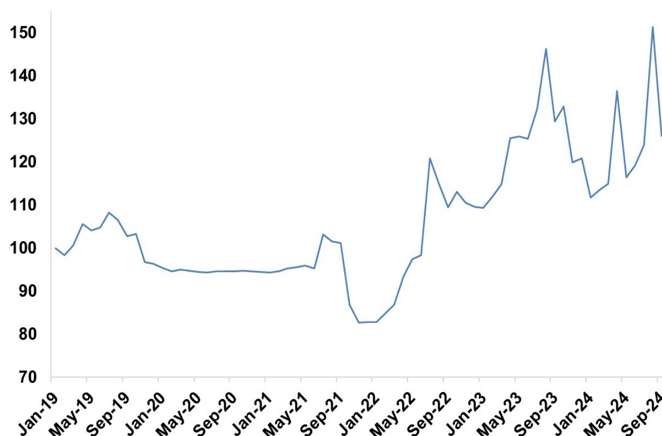
October 27, 2024

Both the holidays and the attack on Iran are behind us

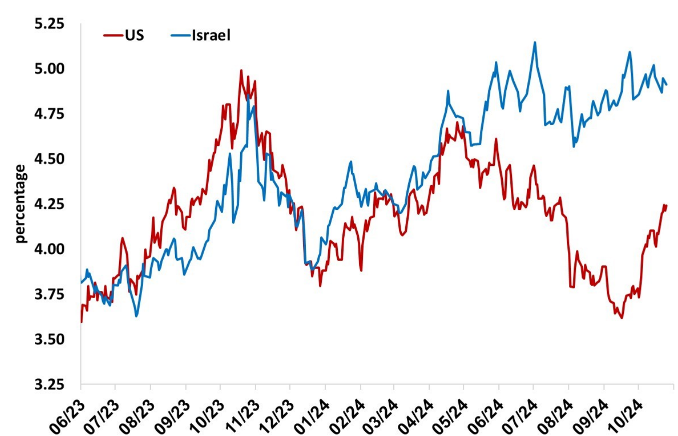
- **Domestic markets are having difficulty keeping up with geopolitical events, and news that in the past would have rattled markets in both directions has had little impact so far.**
- **The huge military expenditure has supported GDP growth this year, and under the assumption that hostilities will cease, this will detract from GDP growth next year. The planned tax increases coupled with elevated inflation, are expected to erode wages for large segments of the population. In our opinion, these two factors will result in slow growth of about 2.0% in 2025.**
- **The domestic bond market places much credibility in government policy, as we see that long-term unindexed bond yields remain relatively stable, even though yields in the US have increased.**
- **The CPI for September, which declined by 0.2 percent, does not indicate a moderation in inflation. We expect inflation to reach 3.2 percent over the next 12 months.**
- **Although the markets reflect the possibility of a rate hike next year, our assessment is that the probability of this is minimal, and that it will only materialize in a situation of significant deterioration in the level of hostilities.**

Domestic markets are having difficulty keeping up with geopolitical events, and news that in the past would have rattled markets in both directions has had little impact so far. Uncertainty is so elevated that it is even difficult to define events as having a positive or negative impact on markets, and much depends on circumstances and interpretations. Thus, for example, the air force attack on Iran is perceived as positive for the markets, due to the widespread interpretation that it will not provoke a retaliation, and it reduces the uncertainty of the waiting period before Israel's strike. The assessment may be reversed if this interpretation shifts due to an unexpected event. One thing is clear: the growing economic damage will persist in line with the level of warfare. The Jewish holiday season fell this year on the month of October. The North was closed to visitors, and in the rest of the country as well the holiday spirit was rather subdued. Our assessment is that this impact will be reflected in consumption data for October which will underline that economic growth has stalled. The Bank of Israel and the International Monetary Fund significantly reduced their growth forecasts for the current year to 0.5 percent and 0.7 percent, respectively, meaning

Sharp volatility in airfare prices
Travel abroad price index, Jan. 2019=100
Source: CDS



The yield differential between Israel and the US has narrowed
10-year government bond yields (local currency)
Source: Terminal, Bloomberg



that GDP per capita will be lower than that of 2022. Israeli households do not fully feel this yet, partly because part of the loss of GDP is reflected in the decline in income of Palestinian workers who used to work in Israel, and partly because of the government's generous compensation policy, which creates income for households without any real contribution to GDP.

Naturally, the range of GDP forecasts for 2025 is much broader than that of this year. The Bank of Israel expects that growth will be strong — approximately 3.8 percent, even under the assumption that the war will continue through the first quarter. Credit rating agencies are more cautious, believing that the economy will expand by modest rates of 1.5% (Moody's) to 2.2% (S&P). Within this broad spectrum of forecasts we are leaning towards the more pessimistic forecast, due to our assessment that fiscal policy will become very restrictive when the war ends. **The huge military expenditure has supported GDP growth this year, and under the assumption that hostilities will cease, this will detract from GDP growth next year. The planned tax increases coupled with elevated inflation, are expected to erode wages for large segments of the population. In our opinion, these two factors will result in slow growth of about 2.0% in 2025.**

The budget is due to be approved by the government this week, although many of the proposed measures to reduce the deficit remain controversial. **The domestic bond market places much credibility in government policy, as we see that long-term unindexed bond yields remain relatively stable, even though yields in the US have increased.** The yield differential between the 10-year Israeli bond and that of the US Treasury narrowed to about 70 basis points, after already reaching 130 basis points in September. At the same time, we also see that the sovereign risk premium in global markets declined slightly (before the attack on Iran) to about 170 basis points for a ten-year duration.

The CPI for September, which declined by 0.2 percent, does not indicate a moderation in inflation. The index was strongly impacted by a sharp decline of 16.7% in airfare in September. Our assessment is that most of this decline will be corrected in October’s CPI (holiday period). The government's tax increases are expected to be a significant factor which will impact inflation in the coming year, from higher VAT to taxes on electric vehicles. The shortage of workers has supported rapid wage growth both in nominal and in real terms, thereby halting the moderation in inflation. **We expect inflation to reach 3.2 percent over the next twelve months** (monthly forecast table attached on page 3).

Although the markets reflect the possibility of a rate hike next year, our assessment is that the probability of this is minimal, and that it will only materialize in a situation of significant deterioration in the level of hostilities. The current interest rate is restrictive relative to inflation expectations, and in light of weak growth forecasts which have been reduced due to the prolongation of the war. On the other hand, it is difficult to envision a reduction in rates, with the annual inflation rate expected to approach 4.5 percent y/y in the first quarter of next year. Under these circumstances, it is reasonable to assume that the interest rate will remain stable for many more months.

BOI Rate and CPI Forecast			
BOI Rate		CPI	
December 2024	4.50%	Oct 2024	0.6%
12M Forecast	4.50%	Nov 2024	-0.1%
		12M Forecast	3.2%

CPI - Forecast for the coming year

Month	Monthly Change (%)	Annual rate of change in last 12 months (%)
Oct—24	0.6%	3.7%
Nov—24	-0.1%	3.8%
Dec—24	0.1%	4.0%
Jan—25	0.3%	4.4%
Feb—25	0.3%	4.3%
Mar—25	0.4%	4.1%
Apr—25	0.4%	3.6%
May—25	0.3%	3.8%
Jun—25	0.1%	3.8%
Jul—25	0.4%	3.6%
Aug—25	0.2%	2.8%
Sep—25	0.2%	3.2%

Forecast change in the CPI index for the coming year: 3.2%
Forecast change in the CPI index for 2024: 4.0%

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