

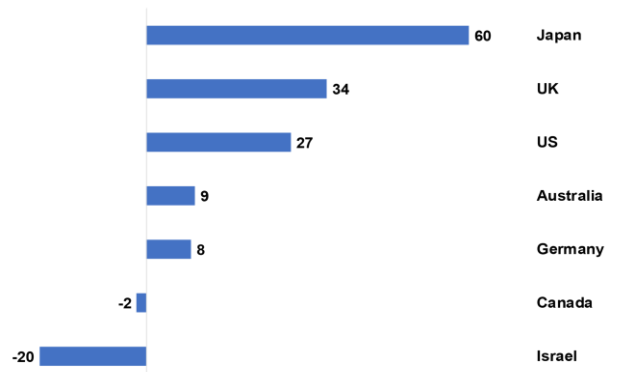
What Will Stop the Shekel's Appreciation?

- The vicious cycle of the shekel's appreciation will eventually be broken either by an exogenous event or by a policy action. Scenarios such as a collapse in global stock markets that shift market momentum, a deterioration in the security situation, or proactive measures such as foreign currency purchases by the Bank of Israel could all contribute.
- The Bank of Israel lowered policy rates, but the message accompanying the announcement was perceived by markets as hawkish.
- Markets were more influenced by the sharp appreciation of the exchange rate, which accelerated following the announcement. As a result, they began pricing in nearly two additional rate cuts this year, bringing the policy rate down to 3.25%. At the same time, inflation expectations continued to decline, reaching 1.5% for the coming year, partly due to lower oil prices.
- In the absence of intervention in the FX market, the remaining policy tool is interest rates, which are highly likely to be reduced again at the next decision meeting.
- The widening bond yield differential between Israel and the United States provides further evidence of investor confidence in a strong shekel over the long term, as well as expectations of a more accommodative monetary policy in Israel in the near future compared to the rest of the world.
- Consumer spending has returned to its pre-war trend, without any significant rebound from the sharp decline recorded in March.

When the shekel has strengthened by nearly 12% against the dollar since the beginning of the year, following a similar appreciation in 2025. The explanation for this likely goes beyond improvements in economic fundamentals and beyond expectations of geopolitical improvement, which have yet to materialize. It appears more momentum driven by investor concerns regarding continued erosion in the shekel value of their assets abroad. This leads them to shift foreign-currency investments into shekels (or hedge their currency exposure), thereby further strengthening the shekel. As the shekel appreciates, more investors sell foreign currency, reinforcing the cycle. This negative feedback loop requires a significant development in order to break it. One could argue that a stronger shekel will eventually reduce exports and increase imports, thereby slowing this trend. However, these economic adjustments occur more slowly than capital flows, which can rapidly influence the exchange rate. Ultimately, **the cycle of shekel appreciation will be interrupted either by an external shock or by a policy action. Examples include a sharp decline in global equity markets that alters market momentum, worsening security conditions, or intervention by the Bank of Israel through foreign currency purchases.** Lower interest rates have only a limited impact on the exchange rate, and in any case, the message markets took from the latest interest-rate decision actually supported further shekel appreciation.

The Bank of Israel cut interest rates, but the accompanying statement was interpreted as hawkish: "In the Committee's assessment, there are risks of a renewed acceleration of inflation - including geopolitical developments and their impact on economic activity and on energy prices, an increase in demand alongside supply constraints, and fiscal developments - while the shekel's appreciation may work to moderate inflation." The Bank's message was effectively: rates have been reduced, but relatively high interest rates may still be required for an extended period in

Contrary to the global trend, Israeli bond yields have declined
YTD change in 10-year government bond yields, BPS
Source: Bloomberg



order to address these risks. Nevertheless, **markets were more swayed by the sharp appreciation of the shekel, which intensified after the announcement. They began pricing in nearly two additional rate cuts this year to a level of 3.25%. At the same time, inflation expectations continued to decline, reaching 1.5% for the coming year, partly due to falling oil prices.** Longer-term inflation expectations also declined to approximately 1.6%.

FX intervention remains part of the central bank's policy toolkit, but the catalyst would likely need to be a threat to the inflation target; in other words, a further decline in inflation expectations. Currently, expectations declined to at around 1.5% for the coming year. In a scenario involving additional shekel appreciation and/or a sharp drop in oil prices, FX purchases by the Bank of Israel cannot be ruled out. **In the absence of intervention in the FX market, the remaining policy tool is interest rates, which are highly likely to be reduced again at the next decision meeting.**

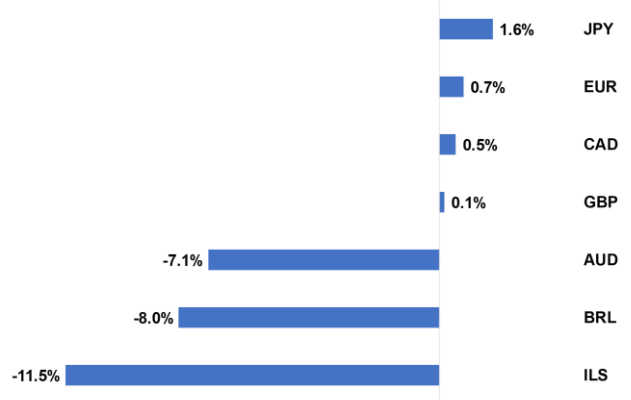
The shekel's appreciation and lower energy prices are expected to contribute to declining inflation prints in the coming months. Petrol prices declined by 3.3% in June, and the sharp appreciation witnessed so far is expected to affect the cost of overseas travel. Our latest inflation forecast projected inflation of 1.7% over the next 12 months, but we are currently inclined to reduced that estimate to a level similar to what is currently priced in capital markets: around 1.5%. In our view, this assessment does not contradict the Bank of Israel's warning that "there remain risks of renewed inflationary pressures," for two main reasons: First, given the high degree of uncertainty, geopolitical conditions could reverse and affect both key inflation drivers: the exchange rate and energy prices. In other words, the inflation outlook has significant tail risks because of the geopolitical environment. Second, there is a timing issue. If exchange rates and fuel prices stabilize at current levels in the coming months, their

impact on inflation will gradually fade. By contrast, the effects of a tight labor market, expansionary fiscal conditions, and global inflationary trends may be more persistent.

The yield on Israel's 10-year government bond declined again this week to 3.75%, while the spread vis-a-vis U.S. 10-year Treasury bonds widened to approximately 70 basis points (with Israel's yields being lower) **The widening bond yield differential between Israel and the United States provides further evidence of investor confidence in a strong shekel over the long term, as well as expectations of a more accommodative monetary policy in Israel in the near future compared to the rest of the world.**

Credit card purchases increased by 12.7% m/m in April, following an 11.9% decline in March. Preliminary estimates for May, based on daily real-time data, indicate stable consumption levels. In other words, **Consumer spending has returned to its pre-war trend, without any significant rebound from the sharp decline recorded in March.**

The shekel has appreciated significantly YTD
USD Exchange rate vs. other currencies (YTD)
Source: Bloomberg



BOI Rate and CPI Forecast			
BOI Rate		CPI	
December 2026	3.25%	May 2026	-0.1%
12M Forecast	3.25%	June 2026	-0.1%
December 2027	3.25%	12M Forecast	1.7%

Disclaimer:

©2022. All rights reserved to Bank Hapoalim. This review is not to be distributed, copied or used in any other way without prior written approval from the Bank. The Bank and/or its employees and/or the writers of the report are not responsible for the completeness or the accuracy of the data and calculations in the review or for any inaccuracy, error, omission or other deficiency in the review or the forecast contained in it, including immediate and/or continuing changes that may change and/or affect the forecast. The Bank and/or its subsidiaries and/or companies that are related to it (hereinafter: the corporations) and/or the owners of control and/or interested parties in any of them are likely to hold on their own behalf and/or on behalf of customers of the aforementioned corporations shares and/or bonds and/or any other security or financial instrument mentioned in this review, and/or are likely to be owners of control and/or interested parties in any of the companies mentioned in this review. In addition, any of the aforementioned is likely to operate in the securities and/or financial instruments that were mentioned in this review on a daily or other basis, to engage from time to time in their sale and/or purchase, despite the said in this report. The said in this review should not be construed as personal and specific investment advice or substitute for advice for the customer with account taken of his data, special and other requirements, financial position, circumstances and the special investment objectives of any person, is not a substitute for them and action should not be taken in accordance therewith, unless after the receipt of personal advice that takes into account each investor's personal requirements and data. This review is intended to serve as an auxiliary tool for the authorized investment advice within the framework of the provision of advice to customers who are signed on an advice agreement, and for that purpose alone. The said in this review does not constitute tax advice and does not presume to be the interpretation accepted by the tax authorities and/or other bodies.