September 1, 2024

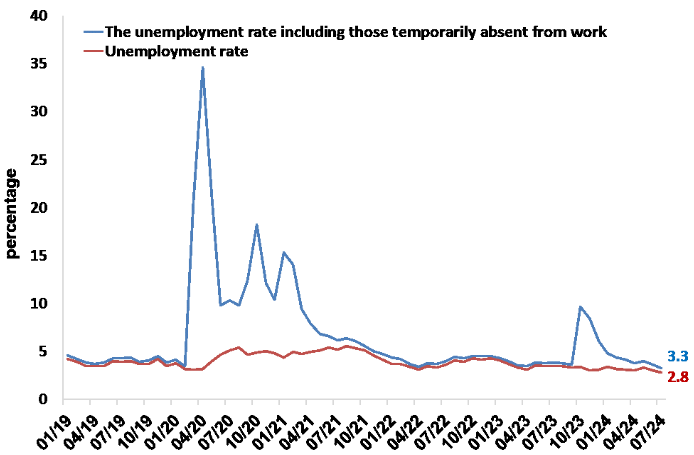
The Shekel Enigma

- **The strong shekel remains an enigma for us, mainly considering the high-risk premium reflected in the debt market.**
- **Economic indicators in July were strong, following a weak second quarter.**
- **The Fed policy rate is expected to be about 0.75 percent below the Bank of Israel rate by the end of 2025; compared with the current situation in which the Bank of Israel interest rate is 1 percent below the Fed rate. This expected differential reflects the current elevated risk of the Israeli economy, and may narrow in a scenario of a rapid end to the war.**
- **Investors want to see a proactive policy aimed at reducing the deficit, even though it is obvious that the deficit will depend first and foremost on the geopolitical situation.**

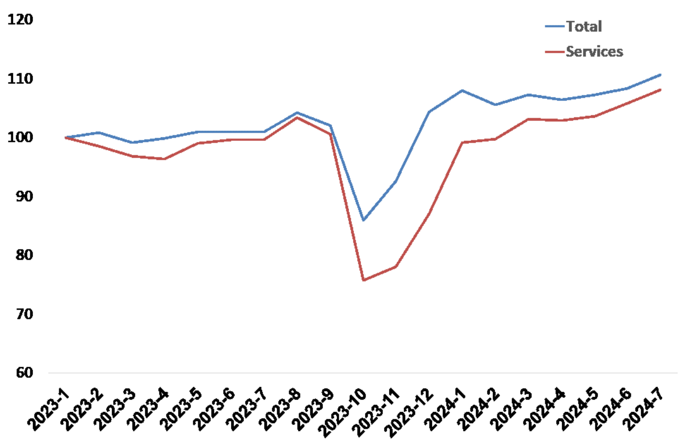
This week, as the return to school commenced, began with harsh news which has harmed the morale of the citizens. Markets continue to fluctuate between the harsh daily reality of war and optimism regarding reaching an agreement and returning the hostages. The shekel strengthened by 1.2 percent against a basket of currencies last week, and the level is 4.8 percent stronger than it was before the war. This strong shekel is explained by higher global equity market valuations; as well as perhaps investors considering a positive scenario that will strengthen the shekel the day after the war. At the same time, we note that foreign investors have reduced their exposure to Israel bonds, even though these bonds are trading at yields way above US bonds. The bottom line **is that the strong shekel remains an enigma for us, mainly considering the high-risk premium reflected in the debt market.**

Economic indicators for July were strong, following a weak second quarter. Credit card purchases increased sharply by 2.1 percent in July compared with the previous month, and industrial exports increased by about 7 percent compared with the average of the second quarter of the year. The unemployment rate declined to a low of 2.8 percent as well. **In our assessment, this positive data regarding activity is influenced by the government's accommodative policy, which has resulted in an increase in the disposable income of some households. This policy buys time, at the cost of a high fiscal deficit. At the same time, this policy**

The rate of unemployment declined to a low level of 2.8%
Source: CBS



Credit card purchases increased
Seasonally adjusted, Jan. 2023=100
Source: CBS



is inflationary because it is implemented while the labor market is tight and there is a shortage of Palestinian workers.

The Bank of Israel maintained the interest rate unchanged, in view of the acceleration of the inflation environment and an increase in geopolitical uncertainty. Inflation is expected to remain high in the coming months, and in January the VAT rate is expected to increase by one percentage point, which will contribute an additional 0.4 percent to the annual inflation rate. In this situation, it is reasonable to assume that the Bank of Israel interest rate will not change at least until the end of this year and even beyond, assuming that hostilities will not be completely over. Markets are currently reflecting only one interest rate cut in the second quarter of 2025, and an additional reduction at the end of the year. **According to this rate path, the Fed interest rate is expected to be about 0.75 percent below than the Bank of Israel interest rate by the end of 2025; compared with the current situation in which the Bank of Israel interest rate is 1 percent below the Fed interest rate. This expected differential reflects the current elevated risk of the Israeli economy, and may narrow in a scenario of a rapid end to the war. In a scenario of a rapid end to hostilities, these interest rate differentials could support a trend of rapid strengthening of the shekel, and will probably result in more rapid loosening than what is currently priced in the market.**

The government is procrastinating in proceeding with a the fiscal framework for 2025. Presenting a budget with severe fiscal adjustments is likely to undermine the stability of the coalition, while on the other hand, a budget with a high planned deficit or a delay in the approval of the budget will undermine the government's fiscal credibility. **Investors want to see a proactive policy aimed at reducing the deficit, even though it is obvious that the deficit will depend first and foremost on the geopolitical situation.** Meanwhile, domestic Israeli bond yields remain at a level approaching 5 percent for a term of about ten years, about one percentage point above the yield on US government bonds. The Ministry of Finance relies more on domestic capital issuance, due to the high-risk premium reflected in dollar denominated bonds; but it appears that the current level of yields reflects a high-risk premium in the domestic market as well.

BOI Rate and CPI Forecast			
BOI Rate		CPI	
December 2024	4.50%	Sep 2024	0.3%
12M Forecast	4.00%	Oct 2024	0.4%
		12M Forecast	3.2%

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