



מודפס גם בעברית

Issue No. 83
January 2010

INVESTOR'S REVIEW

ESPECIALLY FOR LEUMI UK PRIVATE BANKING CLIENTS

Israeli Macro Economic Review

By: **Eyal Raz**, Head of Economics Department, Finance and Economics Division

What's in "Investor's Review"

- Israeli Macro Economic Review
- World Macro Economic Review
- What are the Risks Involved in Investing in Structured Bonds?

Select Indices

	Rate	Return in % December	Return in % 2009
TA 100	1,075	6.12	88.8
TA 25	1,152	5.77	74.86
DOW JONES	10,428	0.80	18.82
NASDAQ	2,269	5.81	43.89
NIKKEI 225	10,546	12.85	19.04

Representative rates December 31, 2009

Editing: Smadar Ilan, Head of Products Marketing Department
Leumi Int'l and Private Banking Division
Tel: 972-3-5149989
fax: 972-3-5149602
Email: smadari@bll.co.il

The interest rate of the Bank of Israel hiked to 1.25%

On December 28, the Bank of Israel (BoI) announced that its interest rate for January 2010 will be raised 25bps, to 1.25%. This is the second month in a row in which the interest rate has been raised. A number of important background factors led to this latest interest rate decision. First and foremost is the inflation environment, which is currently around the upper border of the price stability target range of 1-3%. In the trailing 12-month period the consumer price index (CPI) increased 3.8%, and according to our forecasts, this rate is likely to be even higher in the coming months.

When neutralizing the impact of the increase in prices stemming from government actions (taxes, surcharges), the annual rate of increase in prices was 2.6%, this is according to BoI calculations. The 0.5 percentage point reduction in the VAT starting on January 1, 2010 is expected to have a negligible impact on the annualized rate of price increases.

Market-derived inflation expectations for the coming year stand near the upper border of the price stability target range as well. Against this backdrop, the real interest rate, which is calculated as the BoI interest rate minus inflation forecasts for the coming year, is still negative and is not appropriate for the current state of the economy.

The local interest rate is low from an international comparison

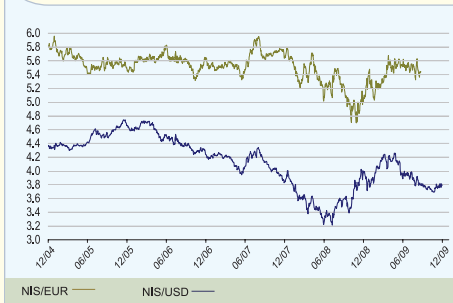
The recovery in the Israeli economy, which is one of the background conditions behind the latest BoI interest rate decision, preceded many other economies among advanced countries. Despite this, the real and nominal interest rates in Israel are low in an international comparison. The interest rate (nominal) of various central banks around the world can be seen in the accompanying graph, with some of the countries in which the interest rate is lower than that in Israel also having a lower inflation environment.

According to the BoI announcement, the main central banks around the world continue to believe inflation will remain moderate in their countries, this against the backdrop of the large output gap, while the BoI claims that in some economies, first and foremost Japan, there are concerns about deflation. Therefore, in these countries expansionary monetary policy is being maintained, this against the backdrop of the state of the real economy and the low inflation environment. In contrast, in Israel the situation is different – both in terms of economic growth and also in terms of inflation. From this we see the need for the continued upward adjustment in the local interest rate.

Furthermore, the BoI also noted the current interest rate hike is part of a gradual process of "returning interest to a 'normal' level..." What is the rate that BoI is tending towards? In our opinion, the central bank is speaking about a real expected rate of 2-3%, which, when assuming a forecast inflation rate of 2-3%, this would imply a nominal rate of 5-6%. As we mentioned also in the past, this process is likely to take approx. two years.

World Macro Economic Review

EUR and USD vs. NIS



By: Liora Caplan, Capital Market Research Department, Investment Counseling

The beginning of 2009 was characterized with a high level of anxiety over the condition of the global financial system, and with question marks over the effect that the credit crunch was going to have on future global economic growth. At the same time the US presidency was going through a transition, as President Bush left new president Obama with a shaky foundation of government aid programs.

In spite of the huge amount of money flowing from authorities to economies, growth rates in the US and other countries during the first half of the year were even worse than expected. In an attempt to improve efficiency and cut costs, companies downsized dramatically, laying off millions of workers and registering a huge drop in investments. At the same time, the consumers, afraid of losing their jobs and not sure how much value they had left in their homes and pension plans, kept their wallets closed. The blow was being felt around the world, but was even more pronounced in advanced economies. The global recession was accompanied by a significant decline in demand levels, easing inflationary pressures. Suddenly, one of the main risks to the global economy became deflation. The bright side of this development was that it helped central banks cut interest rates in order to lower loan costs and stimulate their economies.

TA25



Just as economists' expectations seemed to reach their lows, the second half of the year arrived and so did a change in the economic environment. A gradual improvement in economic activity in the US had a positive effect on the global economy. That meant positive growth rates in many countries as early as Q3. A few driving forces were the source of this improvement, most importantly the aid given by US authorities to local financial institutions. This lifeline was critical for restoring the trust in the financial system, unfreezing credit markets and supporting consumer, investor and business sentiment. All along, governments kept pumping money to the markets and widening budget deficits. Government consumption became the main driving fuel of economic growth around the globe.

Oil prices per barrel (USD)



As the New Year commences, economic reality is still very fragile. There are positive signs of improvement in each of the top important fields in the US economy. The consumer is in much better shape and for now has proved that the love of shopping is still in him, even when under control. This positive development can be felt in both industrial production and the real estate sectors. Obviously, government expenditure and tax relief programs have much to do with this turn for the better. Nevertheless, employment has suffered a huge blow and is not expected to improve dramatically any time soon. This will have a negative effect on the economy, capping further improvement in real estate or private consumption. Naturally, developments in the US will have huge influence on the rest of the world.

Gold prices (USD)



For the coming year, we expect moderate economic growth accompanied by a gradual exit from very expansionary fiscal and monetary policies, in the US and globally. Future developments will depend greatly on the manner in which exit policies are conducted, as the main challenge for many countries will be to achieve a smooth transfer from an economic growth based on government consumption to growth which is based on "real" and more natural demand.

What are the Risks Involved in Investing in Structured Bonds?

By: **David Vardi**, Capital Market Research Department, Investment Counseling

A number of companies recently announced full early redemptions in one of their bond series. This was because of the announcement by the issuers of the notes (liabilities issues) for these series, on executing a full early redemption of the notes. These Notes are the assets that back the bonds issued by the companies. According to the prospectuses of the issues, these bonds can be redeemed early, provided that the companies receive notice from the issuer of the notes. The notices about the aforementioned redemption events, which would be executed according to the bonds' adjusted price, was received only one month prior to the date of the early redemptions. Indeed, one of the important risks to consider when weighing an investment in structured bonds is the risk of their early redemption.

The risk level in structured bonds is derived from a number of elements:

The credit risks of the issuers of the notes: in addition to the credit risks of the bonds issuer, bondholders are exposed to the credit risks of the backup bank, which is exclusively responsible for transferring the receipts to the bonds issuer and forms the sole financing source for payments for bond holders. The bankruptcy of the bank would lead to non receipt of payments pursuant to the bond terms and conditions. For example, in Shachrit (unindexed) bonds (series H) the issuer of the Notes is a German bank, Dresdner Bank, while Shachrit Issues Ltd. is a Special Purpose Company (SPC), which was established by Express Financing Ltd. and its sole business is issuing bonds backed by the aforementioned notes. After the merger of Dresdner Bank into Commerzbank, the latter adopted all the rights and liabilities of the former. The international ranking of Commerzbank is A/Negative. Nevertheless, the Shachrit series H bonds received a maximum ranking from the Maalot ranking company (AAA). Inter alia, this ranking is based on the ranking of the issuer of the notes. However, the Maalot ranking relates to the credit risk of the bond only, without reflecting the market risks. This includes the risks involved in the interest payment terms and conditions during the lifetime of the bond, or of the risk of shortening the average lifespan deriving from an early bond redemption.

Market Risks: Coupon payments for the structured bonds are not fully guaranteed and, for the most part, are contingent on a number of conditions: for example, in the Shachrit (series H) bonds, the bonds' coupon rate (which is fixed and unindexed at a maximum rate of 10.5% per annum) is accrued on a daily basis and paid quarterly, for the days on which the annual inter-bank interest rates fall are in the range of 0%-7%. Should there be a sharp interest rate hike in the future, the risk that the inter-bank rate will exit this range will also intensify. Currently, there are series in the market that do not comply with the credit conditions for

coupon payment. For example, in the Shachrit bonds (series G) interest is accrued on a daily basis and paid quarterly for the days on which the following two conditions exist accumulatively: (1) The shekel-dollar exchange rate exceeds NIS 3.83; and (2) the difference between the unindexed interest rate for ten years and the unindexed interest rate for two years is positive. Since mid-August 2009, the shekel-dollar exchange rate has been lower rate than the minimum condition for receiving interest and, consequently, no interest was paid for this period.

The possibility of the the redemption of the notes: As aforementioned, generally, under certain circumstances, in which the special-purpose company receives notification from the issuer of the notes on an early redemption on his part, there is an option (as described in the prospectus) for an early redemption of the structured bonds. These redemptions are executed according to the bonds' adjusted value, i.e., at a price of 100% of the bonds' nominal value with the addition of accrued unpaid interest, which presents a fair price for these bonds. However, since the bonds are traded in the market, they are exposed to a degree of price volatility. At this point, investors should use their discretion and exercise caution when acquiring bonds at a higher price than "par" (the bonds' adjusted value), since a notification of early redemption is likely to cause them capital losses. Shachrit bonds (series H) have been traded at close to par for some time, despite their high ranking, the relatively low risks for interest payments and the relative stability of the backup bank, which support the negotiability of the security at a low yields level. Apparently, in view of the high interest that the backing bank has to pay every quarter, the aforementioned decided to return the loan that it had taken and avoid additional high payments in the future. It should be noted that, in view of the spread between the high interest rates, which the backup banks have to pay and the low interest rates in the markets, recently the risks of full early redemption in additional structured bonds have intensified. These include Shachrit (series D and F) bonds etc.

In conclusion, when contemplating an investment in structured bonds, an emphasis should be placed on identifying the notes issuer; the anticipated coupon rates for this investment; and the risk level in principal payments (sometimes the special purposes companies offer a product for which the principal payment itself is uncertain) should be estimated; and the fact that, because of the risk of early redemption, the instrument does not have a true potential for capital gains should be taken into account. In view of the aforementioned risks, it would appear that investors must demand suitable compensation, in the form of a relatively high return, for their investment.

Going Further – Bank Leumi (UK) plc*

Leumi Private Banking

Leumi Private Banking is proud to protect and enhance the wealth of its international clients and their families through a comprehensive range of private banking, investment and trust services.

We welcome new clients.

Banking Services

We offer a full range of banking services in all major currencies, accept deposits for sums of £50,000 and above (or equivalent in other currencies), and provide payment services, cheque books and charge cards.

Investment services

For sums of £250,000 and above (or equivalent in other currencies) we offer both Advisory and Execution Only Services. We can offer investment advice on fund choice and also asset allocation and portfolio valuations in all the major currencies. Invested cash can be held in the currency of your choice.

Wealth Planning Solutions and Fiduciary Services

We structure, establish and administer trusts, private investment companies registered in various locations, and foundations, through our subsidiary in Jersey.

Treasury and Dealing Services

Our Private Banking Relationship Managers, in conjunction with our Dealing Room, are able to offer a full dealing service and provide you with the latest market information. In addition they can offer a range of options, future and derivative strategies for sophisticated investors.

Foreign Exchange Services

We offer immediate competitive pricing in all major currencies, covering spot and forward periods and swaps trades. We offer access to a range of derivative instruments as investments, or for protection against interest, exchange, and equity risk. Our treasury team is positioned to facilitate timely execution.

Lending

We provide lending facilities against portfolios of securities, bank guarantees, UK properties, cash deposit, and on a back-to-back basis (a loan backed by a deposit held in the same or different jurisdiction).

Executive Mortgages

We offer a flexible five-year, interest only mortgage with a multi-currency option intended for UK and expatriate high net worth individuals for the purchase of their residential property in the UK.

*Bank Leumi (UK) plc is authorised and regulated by the Financial Services Authority.

Leumi Private Banking

Bank Leumi (UK) plc
020 7907 8008
PrivateBanking@bankleumi.co.uk www.bankleumi.co.uk

Leumi Jersey

Bank Leumi (Jersey) Limited** provides a full range of private banking services for clients who are looking for an offshore location with security, confidentiality and in a stable, reputable environment. We have an experienced team who are able to provide a flexible and focused approach to meeting individual clients needs.

Additional services available from our offices in Jersey:

From Bank Leumi (Jersey) Limited Banking for Non-Domiciliaries

We routinely provide accounts where capital and income are segregated. This, combined with our attractive interest rate, should prove to be particularly beneficial to clients who are not UK domiciled but resident there. It may also be attractive in other circumstances.

Offshore Custody

We are able to provide offshore global custody arrangements for trusts, companies and individuals, whose planning include such requirements.

Offshore Executive Mortgages

This product is most applicable for UK residents who are not domiciled for tax purposes in the UK and who have foreign earnings. These clients may purchase residential or investment property in the UK using a Bank Leumi (Jersey) Limited flexible five year, interest only mortgage with a multi-currency option.

From Leumi Overseas Trust Corporation Limited*** Fiduciary Services

The formation and administration of Trusts, Foundations and Companies is at the core of our service. Whether the goal is to provide an orderly transfer of assets to future generations, to maximise returns by investing within a tax-efficient structure, or any other aspect of international planning, we can assist in the establishing and managing the most appropriate holding vehicle.

Family Office Services

The idea of having one overall focal point for many areas of planning and investment is appealing to many clients and we are able to provide this service from one office. As an enhancement, we are able to provide Private Trust Company services, where family members may be closely involved in the trustee decision making – giving an element of control if required.

Wealth Planning Solutions

Working in conjunction with tax advisors, we can provide a wide range of solutions for families or companies looking to efficiently manage and protect assets whilst planning for the future. Wherever there is a requirement for fiduciary services from an experienced team, in a reputable and stable jurisdiction, we will be able to assist.

**Bank Leumi (Jersey) Limited is regulated by the Jersey Financial Services Commission.

For more information phone: 01534 702 525

***Leumi Overseas Trust Corporation Limited is regulated by the Jersey Financial Services Commission.

For more information phone: 01534 702 500

info@leumijersey.com

www.bankleumi.co.uk

The data contained in and attached to this message has been prepared given the research, knowledge and investment views of Bank Leumi le-Israel BM or on advice from the research facilities and data sources of third parties. It is intended solely for information purposes and not as an invitation to participate in any particular trading strategy. It should not be used as the primary basis for trading decisions. No representation or warranty can be given with respect to the accuracy or completeness of the information herein.

This documentation does not constitute a recommendation or invitation to buy, or the solicitation of an offer to sell any product, security, note or instrument. There may be significant risks associated with any product, security, note or instrument described herein including, but not limited to interest rate risk, price risk, liquidity risk and credit risk. The value of investments can fall as well as rise and an investor may not get back the original amount invested. Any exposure to foreign currencies may also cause the value of an investment to fluctuate. Past performance is not necessarily indicative of future results.

We are not acting as your financial adviser or in a fiduciary capacity in respect of any transaction with you unless otherwise expressly agreed by us in writing. Before entering into any transaction you should take steps to ensure that you understand the transaction and have made an independent assessment of the appropriateness of the transaction in the light of your own objectives and circumstances, including the possible risks and benefits of entering into such transaction. You should also seek advice from your own advisers in making this assessment.

The information contained in or attached to this message is privileged and confidential. The information is intended only for the use of the individual or entity named above. If the reader of this message is not the intended recipient, you are hereby notified that any dissemination, distribution or copying of this communication is strictly prohibited. If you have received this communication in error, please notify us immediately by telephone or e-mail and delete this message.