



Private Banking
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"Leumi - The Best Private Banking in Israel"

(Euromoney Survey, February 2009)

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UK & Jersey

Select Indices

	Rate	Return in % February	Return in % 2009
TA 100	604	0.62	9.00
TA 25	666	0.81	3.87
DOW JONES	7,063	-11.72	-18.52
NASDAQ	1,378	-6.38	-11.15
NIKKEI 225	8,568	-5.32	-14.57

Correct to 28.02.2009

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

INVESTOR'S REVIEW

ESPECIALLY FOR LEUMI UK PRIVATE BANKING CLIENTS

Macro Economic

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

Israel's consumer price index fell in January; a decline is expected for all 2009

The consumer price index (CPI) fell 0.5% in January; while in the trailing 12-month period the index climbed 3.3%. One of the main contributors to the fall in last month's CPI figure (-0.3 percentage points) was the transportation and communication component, which was strongly affected by the drop in fuel prices; the housing component also fell 0.7%, thus contributing close to -0.2 percentage points to the drop in the general index. At the same time, the annualized rate of increase of the housing component accelerated in January, reaching 12.5%. The housing component is more volatile than the general index – in the last two years the annual changes in this component have ranged between -6% and 12.5%. The impact of the shekel – US dollar exchange rate on this component, which in the past was substantial, has greatly weakened over the past year. However, significantly in January there was a change in the trend - the proportion of renewed housing rental contracts denominated in dollars increased substantially, apparently in response to the depreciation of the shekel vis-à-vis the dollar to more than NIS 4:US\$1. Looking forward to the remainder of the year, the weakness in the state of the local economy is expected to change the trend in the housing component. This change in the trend is likely to have a significant impact on the CPI, which is expected to fall in 2009, after an increase of 3.8% in 2008.

The Bank of Israel introduces a new monetary tool – open market operations through government bonds

The Bank of Israel (BoI) recently announced it will add a new tool for conducting monetary policy. The central bank will purchase government debt of different types and maturities in the secondary market. Some of the monetary tools currently employed by the BoI include loan tenders and monetary deposits, the issue of T-bills (Makams), repurchase agreements and foreign currency purchases. Thus the process is continuing by which, after more than ten years of non-involvement in the markets (e.g., foreign currency, bonds), the BoI is returning to the markets and renewing its involvement with them.

These transactions are designed to facilitate an increase in liquidity in the economy. In addition, this tool is intended to enhance the effectiveness of current monetary policy. In other words, the BoI believes that through this process it will also have a dampening influence on longer-term interest rates; the central bank is no longer relying solely on directly affecting short-term interest rates, as it has done until now.

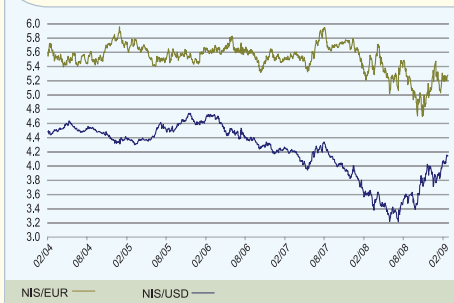
It is worth asking why the BoI has chosen to implement this tool now, especially since the yield-to-maturity for government bonds is at the lowest point ever. The fact the BoI has taken this step gives a strong indication of its concern for additional deterioration due to the financial and economic crisis and for the expected fiscal deficit and the future need to finance it. It can be assumed that an initial trial run of this financial instrument was launched now so at the moment when it is truly needed, perhaps later this year, the BoI will more effectively be able to use it.

In addition, it appears that generally there is a high degree of uncertainty, both in the manner of implementation of new economic monetary instruments and also in the manner in which the use of these tools will be phased out after the economic crisis has passed.

World Macro

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

Euro and USD vs. NIS



TA25



Oil Prices per Barrel (USD)



Gold Prices (USD)



February has come and gone and the negative economic trends continued. Macro data published last month reflected an even darker economic reality than previously thought. Now it is possible that the contraction in U.S. GDP for Q109 will be even worse than the whopping 6.2% annualized contraction registered in Q408, a decline that exceeded expectations. Meanwhile, the Q4 financial results season is coming to an end with many companies reporting a two-digit drop in profit. It is worth noting that despite the improvement in the U.S. trade deficit, it still had a negative effect on growth, as a result of a sharp decline in demand for U.S. exports. Additionally, the decline in private consumption was also larger than estimated at -4.3%.

As if all of this wasn't enough, the level of anxiety in the markets rose further after Treasury Secretary, Timothy Geithner, announced a new plan for supporting the ailing financial sector. It seemed this plan would have an uplifting effect, but instead investors reacted negatively. The plan's vagueness was interpreted as an indication the new administration is having difficulty in finding a solution and that no quick fix is available. In the mean time, various companies found themselves falling into deeper trouble, among them **AIG**, which turned to the administration for a fourth bailout, after losing almost \$62 billion in a single quarter. Past arrangements with the government were based on the premise that the company would be able to find buyers for some of its assets and use the sale proceeds to repay its debts. The severity of the economic crisis has meant that **AIG** had trouble raising enough money to cover the repayments of the loans. The ultimate solution to **AIG's** troubles will likely incorporate a transfer of some of the company's assets to the government until they can be sold.

Possible nationalizations of additional U.S. financial institutions took center stage this month and generated a great deal of fear in the markets. A further deterioration in **Citigroup's** financial situation caused different public figures, including Senate Banking Committee chairman, Christopher Dodd, to discuss publicly the possibility of nationalizing major U.S. banks. These discussions upset the relative calm attained in the markets since October and created a large sell-off. Fed Chairman, Ben Bernanke, helped restore some calm with his announcement that a privately held financial sector is what is best for the U.S. Nevertheless, by the end of the month **Citigroup** urgently required more financing, and the administration announced it was planning to convert \$25 billion worth of preferred shares to regular stocks, thus gaining a 36% hold of **Citigroup's** equity.

The administration is currently performing "stress tests" to check banks' capital adequacy in different macroeconomic scenarios. Once these tests are complete, more bailout money will likely be provided to those banks that need it most. However, further delay by the new administration in formulating an orderly and detailed plan to help the financial sector will likely be costly for the U.S. By now, reality has shown us that handing out cash and performing part or full nationalizations is not enough to stop the bleeding. As long as there is no plan that will adequately solve the problem of "toxic" assets plaguing financial institutions' balance sheets, negative sentiment is expected to remain in the markets.

India – An Economic Review

By: **Itamar Dar**, Capital Market Research Department, Investment Counseling Division

India is the third largest economy in Asia with an annual GDP of \$1.2 trillion. The Indian economy has grown at an average rate of 8.6% over the past five years. Recently there have been noticeable signs of a slowdown in growth with the Q308 growth rate declining to 7.6%. Updated forecasts regarding the future growth rate are not encouraging; the local government forecasts the growth rate for the budget year ending March 31st, 2009 will decrease to 7.1%. The Reserve Bank of India (RBI) expects the growth rate to reduce even further to 6% during the following budget year.

In contrast to the trend in other countries, the increase in the Indian budgetary deficit derives primarily from the anticipated decrease in income from taxation and less from the government's various aid programs. Up until now, the government has authorized two aid programs totaling \$13 billion (only approx. 1% of GDP) for the economy. This is in contrast to other government aid programs in Asia, such as \$8.6 billion and \$576 billion (3.5% and 18% of GDP) in Thailand and China respectively.

Industrial Production and Exports

During the past five years, industrial production in India has increased at an annualized rate of 8.4%. However, for the first time in 15 years, negative growth of 0.3% was recorded in October 2008. While the index returned to a positive 2.4% in November, it once again dropped, to -2.0% in December. A slowdown has also been recorded in Indian exports.

Monetary Policy and the Domestic Currency

In view of the rapid growth that India underwent and the alarming rise in the inflation rate, trends that reached their peak in mid-2008, the RBI adopted a restraining monetary policy, raising the repo interest rate from 6% in 2004 to 9% in mid-2008. However, the global economic slowdown and a halt in inflation resulted in a complete turnaround in the central bank's policy. Since October 2008, the repo rate has been cut a number of times, most recently to 5.5%. In view of the continuing economic slowdown and forecasts of a decline in India's growth rate, further rate cuts cannot be ruled out.

Bonds

Indian government bonds quoted in rupees are traded with a redemption yield of 4.8% and 5.9% for periods of two and ten years, respectively. The bond yield reached approx. 9.5% by mid-2008, but, because of the slowdown in the inflation rate, which was accompanied

by intensive repo rate reductions by the RBI, since then long and short bond yields have declined by 370 and 470 basis points respectively.

The attractiveness of an investment in Indian government bonds is largely dependent on the depth and duration of the global economic recession and the RBI's continued repo rate reductions. We believe that, while the repo rate will indeed be cut in the future, most of the yield declining process along the length of the government curve was already exhausted in Q408. In contrast, we reiterate the budgetary deficit will force the Indian government to increase its volume of capital raisings, a trend that will support yield hikes. The fear of another decline in the Indian economy, which would result in lowering its credit ranking, a decrease in the value of the domestic currency and an increase in the risk premium on an investment in local government bonds is also noteworthy. Consequently, we are convinced that an investment in Indian government bonds is currently not recommended and constitutes a high risk.

The Stock Market

The most popular index amongst foreign investors is the Sensex 30, which comprises the shares of 30 companies. Over the past five years, the index's total return was 67%, equivalent to an average annual return of 11%. However, over the past 12 months, the index's return was -45%. While the Indian shares index is low, especially when compared with past and global price levels, it is currently difficult to assess to what extent the global recession will affect future results of Indian companies and to what extent the Indian index is indeed "cheap," as would appear at a first glance. Furthermore, it is worth noting that, at 1.9%, the index's dividend yield is relatively low compared with dividend yields of 4.1% and 3.7% in the Brazilian Bovespa and Chinese FTSE/Xinhua indices respectively. We are not convinced that any substantial upward spiral is expected in the index, at least as long as the flow of discouraging economic news throughout the world continues.

Conclusion

At the current point in time, we are convinced that an investment in the stock indices of other developing countries, such as China, is preferable to an investment in the Indian index. However, we believe that the growth potential in India is great and over the long run it will return to a growth rate of close to 10%, and will be back on our list of recommended emerging markets for investment.

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Leumi Private Banking

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

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For more information phone: 01534 702 500

info@leumijersey.com

www.bankleumi.co.uk

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