Global View

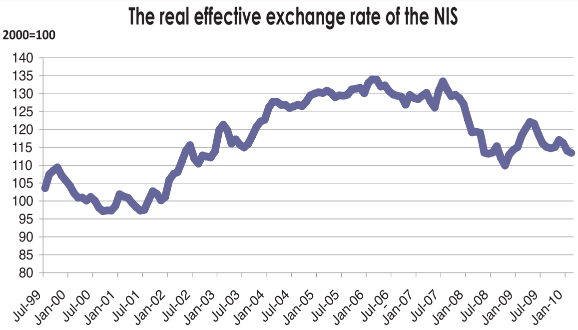
Economic Review

2nd Quarter 2010 | No. 21

Israel

The real exchange rate has appreciated…

In March the shekel strengthened vis-à-vis the US dollar by 2.2%, and by 3.1% vis-à-vis the euro. The effective nominal exchange rate, calculated by the Bank of Israel (BoI), and which represents the development of the shekel vis-à-vis the currencies of Israel's main trading partners, also showed a strengthening in the shekel, of 2.3%. This strengthening trend in the local currency has been continuing for a number of months.



Source: Bank of Israel
This index is based on a 38 currency trade weighted basket.
The real exchange rate reflects the change of the Shekel's exchange rate minus the inflation differential between Israel and the countries included in the basket.

When analyzing the real exchange rate of the shekel (which is the nominal exchange rate that takes the inflation differencial between Israel and other countries into account), it turns out the shekel is today at a competitive level that is only 3% better than the low point of competitiveness that it was at in October 2008. What this means is that exchange rate has a negative impact on the revenues of exporters. In particular, this affects products that are especially sensitive to exchange rate fluctuations (for example, traditional industries), and which are in the especially competitive markets of "off-the-shelf" goods.

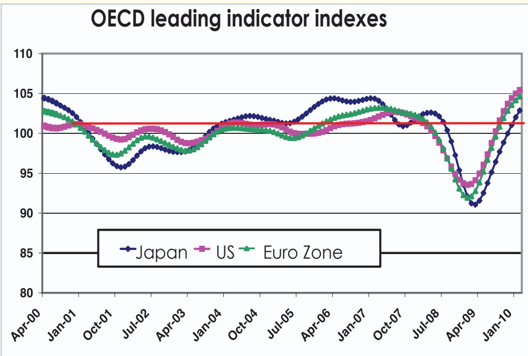
However, it has previously been noted by us that in an analysis of the impact of the exchange rate on exports it is worthwhile to take into consideration that the makeup of exports from the Israeli economy is high-tech intensive. On this regard, it should be remembered that an analysis carried out by the BoI raised the point that the real exchange rate indeed does not have a clear impact on the exports of the advanced sectors; but in the mixed sectors, e.g. low- to medium-technology, there exists a clear positive impact.

Currently, in light of the difficulty of the central bank to have an impact on the nominal exchange rate, and certainly also on the real exchange rate, it is worthwhile to analyze various other methods that will better allow the sectors of the economy, primarily those that are employment intensive, to better deal with the appreciation of the local currency that is occurring as a result of the positive underlying fundamentals of the economy, as well as the effect of developments in the currencies of the world.

...but there are encouraging signs regarding economic activity overseas

Despite the deterioration in the degree of export competitiveness as reflected in the real exchange rate (a negative "price" effect), the development of exports is affected also by quantitative changes. In this regard, in recent months there have been increasing signs of improvement in most of Israel's trading regions, and this is creating export demand.

The accompanying graph shows the "Index of Leading Indictors" of the OECD. The purpose of this index, which weighs different indicators of economic activity, is to indicate a turnaround point in economic activity six months in advance. The "100" mark represents the long-term trend of the index of industrial production that acts as the reference series, since this monthly index is similar to the development of changes seen in the index of leading indicators that is calculated for each country individually. When the index rises above 100, this means there is an expansion in activity, and when it falls and reaches below 100 then a slowdown in activity is expected.



As can be seen in the graph, an expantion in economic activity is expected in each of Israel's three leading trading zones (in particular the US), and this is an encouraging sign for an increase in the demand for Israeli exports in the near term. Signs of a recovery in the US high-tech sector can also be seen in the increase in the Tech Pulse Index, which reflects developments in the US high-tech sector, and consequently impacts Israeli high-tech activity. Thus, despite a weakening in the degree of competitiveness in the exchange rate of the shekel, it appears that in 2010 an increase in global demand will likely compensate for this and nonetheless lead to a nice expansion in Israeli exports.

However, a large degree of divergence in the sector breakdown of exports is expected: an expansion in the high-tech sectors, which are more sensitive to developments in demand and less so to exchange rate changes, and weakness in the more traditional sectors (low-tech), which are much more sensitive to developments in the exchange rate.

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Euro Zone

European GDP growth stagnated in 4Q in comparison to the previous quarter. Exports continued to rise strongly with Germany remaining a main beneficiary of increasing global demand. This trend should continue according to PMI data and order improvements reported by the German VDMA. Reflecting the significant recovery in global trade, the Eurozone export market is assumed to increase close to 7% in 2010. Domestic demand, however, stayed weak with household consumption flat versus 3Q and gross fixed capital declining by a hefty 1.3%. The weakness in private expenditures seems broad-based across sectors. Retail sales, which exclude automobile sales, fell for the seventh successive quarter in 4Q, despite relative strength in December. The situation has not improved at the beginning of this year and the PMI Retail indicator even points to a deterioration. Consumption is obviously dampened by weak labor market prospects, which will probably remain unsupportive over coming months. Contrary to the US, many European companies tried to retain labor, at least on a reduced basis, despite plunging output. Disposable income may develop positively in Germany given the stabilization of the employment market there and some fiscal stimulus, but this should be more than offset by aggressive fiscal tightening in Ireland and Southern Europe. Precautionary savings should remain high in this environment. In light of the uninspiring perspectives we continue to anticipate subdued private consumption for 2010.

Hardly any impetus is anticipated from the investment side. Capital expenditures plunged at an unprecedented rate at the peak of the crisis. Given record low capacity utilization and weak domestic demand, non construction investments should remain sluggish. Construction expenditures fell sharply once again, plunging by 1.1%, which suggests that the correction is still far from over for some countries hit by the real estate markets. Anticipated weak demand and price uncertainty hence continue to weigh on construction investments. Contrary to 3Q, inventories failed to contribute positively to the expansion and government expenditures slightly declined by 0.1%. We expect GDP growth of 1% in 2010. Temporary factors that supported the economy will fade away over time, the process of repairing balance sheets should continue over coming months, private investment is projected to dampen by high levels of unused capacity as well as low demand prospects and fiscally challenged countries will not only impose stringent measures, but also pressure the banking system in Northern Europe.

Annual HICP inflation turned positive in 4Q09 after having reached a low of -0.4% in 3Q09. This pattern was mostly due to strong base effects from past falls in commodity prices. Core inflation is expected to remain close to 1% over the coming months. Later in the year, the rate of inflation is anticipated to increase only modestly, reflecting the gradual improvements in activity. Importantly, the continued weakness in the labor market should keep compensation per employee relatively low, which is supposed to lead to a higher level of productivity, particularly following the elevated unit labor costs growth in 2009. Inflation expectations remain firmly anchored, in line with the ECB's target of keeping inflation rates below, but close to 2% over the medium term. Trends in M3, together with the negative annual rate of growth in loans to the private sector, support the assessment that the underlying pace of monetary expansion is moderate. The development in these aggregates is anticipated to remain restrained. There are interesting trends occurring: annual growth in loans to households has turned positive. This is more than offset by declining growth in loans to non-financial corporations. The latter represents however a classic laggard. Importantly, the very attractive market conditions encouraged enterprises to substitute bank financing by market-based options. The ECB continues to gradually phase out non-standard operational measures. We anticipate the ECB to raise interest rates only later in the year, lagging other central banks. The yield curve should remain relatively steep. Since yields are currently unattractive, we would be very prudent in establishing new positions at current prices, though.

We continue to overweight stocks, but not at the maximum rate. The favorable outlook in respect to the economic environment and subsequent earnings growth favor stock investments. Operating profits are anticipated to rise in double-digits as revenue expansion should finally kick in. Cost cutting will play a more subdued role. Profit margins are generally expected to slightly increase. As central banks will unwind their extremely loose policy, liquidity will be less abundant, thereby moderating a major force of the current upturn. Bonds became very unattractive as an asset class or involve a much higher level of risk to reach an appealing yield. Many investors may therefore opt for equities. Also, after the initial indecisive reaction to policy changes, investors will eventually concentrate on the improved profit picture and take the market ultimately higher.

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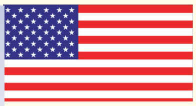

The United States

Spring Thaw

Previously frozen financial markets continued to re-liquefy during early 2010. This was seen in a relentless narrowing of spreads across various asset classes as the search for yield forced investors to trade out of the perceived safety of cash and treasuries for the higher spreads and yields offered by lower rated and longer maturity instruments. This was particularly evident in the U.S. Agency mortgage market where the spread between fixed 30 year mortgage rates and 10-year T-note yields narrowed to record tights. This was mainly attributed to the Federal Reserve's $1.25 trillion mortgage purchase program which ended on March 31. It was also due to a lack of new mortgage supply as the housing market, though stabilizing, still remains fragile with anemic activity in both new originations and refinancing.

Spread tightening was seen in other asset classes as well. Spreads on U.S. Agency debentures have returned to pre-crises levels as participants were more accepting of the government's action in backing Fannie Mae and Freddie Mac even as their losses from delinquent mortgages continued to rise. ABS & CDO spreads on securities backing all manner of receivables (credit cards, auto's, student loans, commercial real estate) also tightened from a year ago. Even activity in the private label mortgage market (sub-prime and ALT-A) has shown some improvement. Finally, spreads on corporate bonds across all rating categories from high grade to high yield enjoyed a significant tightening which bodes well for economic performance.

Too Far, Too Fast

The improvement in financial markets has been dramatic enough for the Federal Reserve to shut down almost all its emergency liquidity programs. In fact, many now argue that the rapid repair of markets is a signal that the Fed must soon reverse quantitative easing by raising interest rates and reducing the size of its balance sheet. These analysts point to spread tightening and stock market gains as predictors of strong economic growth ahead and warn that a failure to soon normalize liquidity will lead to new bubbles and higher inflation.

GDP growth of about 4.0% in the second half of 2009 and expectations of similar growth in this year's first half may be signals that an overly accommodative policy is no longer necessary. Stronger than expected readings on retail sales and industrial production also point to improved economic conditions while various measures of consumer sentiment have indicated less pessimism. In fact, I can sense this positive turn in sentiment. Twelve to eighteen months ago, as the financial crises intensified, it seemed that almost all Americans were wondering if they would lose their job, if their companies would survive or if their retirement savings would be wiped out. Clearly, in such a desperate environment the collapse of consumer spending and economic activity was exaggerated. In today's environment, those who have unfortunately lost their jobs continue to cut back. But the large majority who survived now feel more confident that they will remain employed. This shift, from a population wide public panic that all was lost to a sense that the worst is over, explains the recent revival of consumer confidence and spending.

But is it Enough?

Despite these budding economic signs ("green shoots" in the words of Bernanke), there still remain significant obstacles facing the economy. Chief among these is the lack of robust job creation that is exerting powerful negative forces on housing which, for many Americans, represents either their largest asset or largest liability. In order to break this negative feedback loop, more jobs are necessary and home prices need to rise more steadily. This will allow those homeowners with positive equity to be more confident in tapping rising home equity. On the other side of the ledger, rising home prices will help those mortgage holders with negative equity (currently estimated at about 25% of homeowners) from walking away from their homes and adding to the already record volume of foreclosures.

Yes, the official unemployment rate has fallen to 9.7% from 10.1% in October and yes, 162,000 jobs were created in this year's first quarter compared to a loss of almost 2.3 million jobs in the first quarter of 2009. But the fact remains that 8.2 million jobs have been lost since January 2008, and although the economy is expected to begin creating jobs more consistently, it is still projected that the number of lost jobs may not be regained until 2014. The excess supply of labor, weakness in residential and business construction and only moderate growth in consumer spending will keep core inflation low. This should allow the Fed to keep rates "exceptionally low for an extended period", at least, in my opinion, until the fourth quarter of 2010.

Markets

As stated earlier, equity markets continued to move higher during the quarter with the S&P 500 gaining 5.0% to 1,169. Earnings were generally better than expected as companies were able to improve margins through increased productivity and somewhat higher revenues. Meanwhile, interest rates remained within established trading bands despite better economic activity and the relentless supply of new treasuries to fund the growing deficit now estimated to reach $1.6 trillion this year (compared to $1.4 trillion in fiscal 2009). Two-year note yields ended the quarter at 1.02% versus 1.14% at year-end while the yield on the 10-year was virtually unchanged at 3.83%. The spread between these two maturities rose to a near record wide of 281 bps versus 269 bps in December. This indicates the markets expectation of stable short term rates in the period ahead coupled with concern of higher inflation and rising rates longer term. But however you wish to interpret the spread; it is helping banks to grow earnings and increase capital which is a clear benefit for future economic growth.

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