Leumi Private Banking

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INVESTOR'S REVIEW

ESPECIALLY FOR LEUMI PRIVATE BANKING CLIENTS

What's in **"Investor's Review"**

Israeli Macro Economic Review

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

The composite state-of-the-economy continues upward trend

The composite state-of-the-economy index, published monthly by the Bank of Israel (BoI), rose 0.4% in December, while throughout all of 2009 the index increased by 3.1% (yet, on average the index dropped 1.2%). The index's climb in December was affected by Israel's expansion of foreign trade, while data on activity in the industrial, trade and services sectors, actually indicated a temporary decline. Despite December's industrial data, the long-term trend in the industrial sectors in recent months is positive and reflects a path of recovery in activity, together with a renewed increase in the number of salaried positions in the economy. Additional improvement in the labor market can be found in data from the Central Bureau of Statistics (CBS) that show a fall in the rate of unemployment in the economy in recent months, reaching a level of 7.4% in November 2009, after an increase up to 7.9% in May 2009.

This data, referring to economic activity, indicates the rapid recovery of the local economy, as well as the return of the economy to a positive rate of growth, even in per capita terms. On January 26, the International Monetary Fund published an update to its global economic forecasts. This update indicated an improvement in global economic activity, together with a rise in growth forecasts for various economies around the world. The growth forecasts for Israel were updated recently by Bank Leumi, as well as by the BoI, and today both these bodies forecast Israel's GDP will grow 3.5% in 2010.

The consumer price index in 2009: 3.9%

The consumer price index (CPI) did not change in December (m/m), while in all of 2009 the index increased 3.9%. Two components accounted for most of the increase in the overall index: the housing component increased 5.6% and accounted for close to a third of the rise in the overall index. The housing market was affected last year by the increasing demand for apartments for investment purposes, and by a decline in the costs of mortgage payments as a result of the substantial drop in interest rates. On the other hand, the moderate activity in the economy, primarily in the first half of the year, served to restrain demand.

The second component that stood out because of its increase is that of transportation and communication, which increased 6.5% and thus also accounted for one-third of the increase in the overall index. This increase was affected primarily by the rise in fuel prices (the component in the CPI in which fuel prices are included rose 28% in the past year – contributing one quarter of the increase in the general index). Of course, the increase in various taxes throughout the year also contributed to the overall rise in the index (a contribution of more than one percentage point).

Since the price stability target range of 1-3% was established in 2003, the annual rate of price increase was within this range only in a quarter of the period. Looking forward, it appears that during 2010 inflation is expected to moderate and the rate of increase in prices is expected, starting in the middle of the year, to be within this target range.

Select Indices

	Rate	Return in % January
TA 100	1,059	-0.72
TA 25	1,123	-2.21
DOW JONES	10,067	-3.46
NASDAQ	2,147	-5.37
NIKKEI 225	10,205	-3.30

Representative rates January 31, 2010

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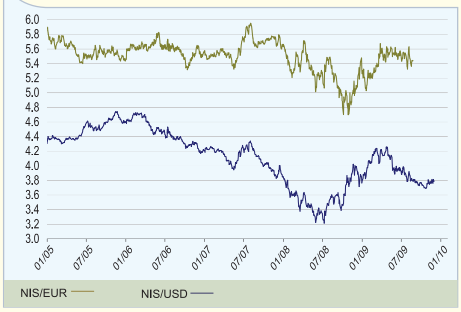
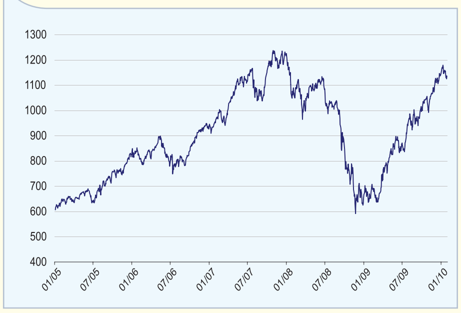
World Macro Economic Review

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

EUR and USD vs. NIS



TA25



Oil prices per barrel (USD)

Gold prices (USD)

January ended with the World Economic Forum in Davos. Naturally, discussions this year focused a great deal on the subject of global financial regulation. During the talks, industry representatives did their best to emphasize the disadvantages of introducing tighter regulation, especially today, while government officials demonstrated the need for regulation as a tool for avoiding the next crisis. It seemed that the latter had the upper hand, as financial institutions, viewed by the general public as the ones to blame for the current crisis, seem to have very little muscle power today. Obviously, banks need governments to support the financial system, strengthen the public's trust in them and cement their trust in each other. But let us not forget that governments are also dependant on the banks and that sustainable economic growth can not happen without them.

The World Forum convened only days after US president Obama announced his proposal for new regulation on US financial institutions which will, among other things, prohibit banks from owning hedge funds and limit them in how much they could trade for their own account. This proposal had a substantial effect on investor sentiment this month, which was largely negative. Thus, as investors turned to safety, stock prices went down and so did government yield curves.

Another risk factor to the global economy is growing government deficits and debt levels. This month, Greece suffered the consequences of a budget deficit which reached 12.7% of local GDP, more than 4 times the maximum allowed by the EU for its members. Speculation as to the possibility of a Greek credit default abounded. Greece's situation is certainly not unique, as other countries' finances (Ireland and Spain for example) are also in disarray.

A challenging regulatory environment and instability of the system due to country default risk are two examples for weak spots threatening the global economy. The credit environment in China is one more. Chinese authorities allowed a fantastic growth of 1.4 trillion dollars in bank credit during 2009, in order to spur economic growth. Now that their goal is achieved (GDP rose by 10.7% over the year) it looks like they might be turning away from such expansionary policies. And not a moment too soon, as there are signs of bubbles forming in the Chinese economy, in soaring real estate prices, worrying over capacity in some industries and boiling stock markets.

Another source of instability, posing what we view as the largest threat to global economy, is government's ability to conduct a smooth transition from economic growth based on government consumption to growth based on "real" demand and investments, whether by individuals or corporates. In this context, the US Q4 GDP data was slightly disappointing. Although the economy grew at an annual pace of 5.7%, private consumption, traditionally the main driver of economic growth in the country, was disappointing. Growth in consumption slowed to 2% (annually), less than in the previous quarter and way beneath the long term average of 3%-3.5%. In addition, much of that growth was encouraged by government spending (i.e. Cash for Clunkers and tax credits for first time home buyers). The main contributor to growth was private investment, mainly due to a dramatic adjustment in inventory levels.

Developments in the Regulation of the US Financial System

By: **Eyal Kaufman** Capital Market Research Department, Investment Counseling

Recently, US President Obama announced a proposal for placing limitations on financial institutions in which deposits are guaranteed by the Federal Deposit Insurance Corporation (FDIC), which he will present to Congress for legislation. According to the president, these limitations are aimed at limiting the size of the banks as well as the risks that they take, in order to prevent a repetition of of the economic crisis that crashed down on us last year.

The administration's proposal is split into two: limiting the extent of the financial institutions' operations and limiting their size.

Limiting the extent of operations - A prohibition on a financial institution's ownership, investing or financing in hedge funds, investment funds or nostro trading that, instead of being linked to providing services to customers, are aimed at generating earnings for the institution itself. Apparently, reference is to "pure" nostro investments (such as investing the bank's own money in hedge funds or private capital funds). A differentiation should be made between this type of activity and nostro activity aimed at reducing the bank's exposure to the risks taken by customers or for the purposes of making a market.

Limiting size – This limitation, which currently applies to the banks preventing them from dominating an exaggerated section of the market, is the prohibition of an increase exceeding 10% in the deposits market segment by the acquisition of, or merging of banks. The administration wants to decentralize the risks in the system and avoid a situation in which the failure of one player would cause the failure of the entire market. According to assessments, the new limitations will relate to the the banks' commitments that do not include regular deposits or Wholesale Funding (financing from external sources such as the FED, loans from the Federal Home Loan Bank and forex deposits etc.).

The affinity of these limitations to the Glass-Steagall Act is clear, despite the efforts made by government clerks to stress the opposite. This law was enacted in 1933 with the aim of separating commercial banks from investment banks or non-bank financial institutions. It was repealed in 1999 – a fact that enabled large banks to return to the investment, insurance and other financial services fields. The large US banks can be divided into two primary groups: The first group deals primarily in investment banking and its most notable representatives are Goldman Sachs and Morgan Stanley. The second group is that of banks characterized by traditional banking alongside activities of investment banking such as JP Morgan and Bank of America. It would be reasonable to assume that limiting the extent of activities would have a greater effect on the first group, while limiting size would have a greater effect on the second group.

An exact definition of the limitations and, all the more so, their enforcement, are expected to be proven as being fairly complicated tasks. During the recent crisis, the large banks reduced their pure nostro trading, which was executed exclusively with the banks' money and solely for the purposes of the banks' earnings. However, there are still nostro activities that are executed simultaneously with customers' activities, whether for bridging the banks' risks against the customers' positions or for the purposes of making the market. Another problem with limiting the extent of the banks' activity is in the nostro investments. It is unclear, for example, what the position is of funds managed by the banks, or by external entities in which there is customers' and bank's money, or the money is managed for the customers' and the bank only charges a commission for the services.

Similarly, in the context of limiting size, at the moment, it is not clear whether reference is to the limitation of growth or the current size. We reiterate that the current size of JP Morgan and to a certain extent of Bank of America is the result of the government's appeal to the banks to take over the banks that had failed. It would be somewhat odd if the administration were now to request these banks to sell these assets.

The future economic growth of the US is also dependent on the banks and large financial institutions reverting to the regular activities of extending loans. The administration is aware of this and, in other settings, it is trying to encourage the banks to revert to extending loans, with all its might. The Wholesale financing activity has weight in the US credit market and, therefore, it would be reasonable to assume that the administration will adopt measures that would cause shock waves in this market. Furthermore, the proposed limitations could prejudice the American banks' competitiveness against foreign banks operating in the US, unless, of course, banks throughout the world adopt similar limitations. For the moment, this does not seem to be the case.

According to analysts' assessments, should these regulations be applied, they would have relatively little effect on the banks. We reiterate that, according to chairperson of the House Financial Services Committee, Barney Frank, it would take 3 to 5 years until this proposal becomes a regulation or law and is applied practically. He believes that there is a great chance that the fate of this reform will resemble that of another reform demanded by the president – the health reform.

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