



מודפס גם בעברית

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### What's in "Investor's Review"

- Israeli Macro Economic Review
- World Macro Economic Review
- India

### Select Indices

	Rate	Return in % October	Return in % 2011
TA 100	1,006	5.33	-16.55
TA 25	1,114	5.19	-14.53
DOW JONES	11,701	7.18	3.26
NASDAQ	2,605	8.21	1.19
NIKKEI 225	8,835	3.30	-12.13

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# INVESTOR'S REVIEW

ESPECIALLY FOR LEUMI LUXEMBOURG PRIVATE BANKING CLIENTS

## Israeli Macro Economic Review

By: **Sagit Cohen**, Economics Dept. Finance and Economics Division

**The Bank of Israel interest rate for November will remain unchanged at 3.0%**  
On October 24 the Bank of Israel (BoI) announced its interest rate will remain unchanged at 3.0%. This follows a 25bps cut in the central bank's rate in October. The interest rate decision, which is the first such decision accepted by the monetary committee appointed in accordance with the new Bank of Israel Law, was in-line with the expectations of forecasters in the market.

This "wait-and-see" policy taken by the BoI in its latest interest rate decision characterizes the actions of many central banks around the world, and it is the result of the high level of uncertainty in the markets that stems partly from the inaction of the decision makers in the Euro block. This inaction is primarily political, and the prices of bonds and other instruments in the global financial markets already incorporate to a high degree relatively pessimistic scenarios, inasmuch as each decision to be accepted will be reflected in the price.

The BoI notes in its interest rate announcement that keeping the rate at the current level leaves the bank with plenty of room for reaction to occurrences in the global and local economies. This room for reaction was created thanks to the rapid response of the BoI to the signs of recovery of the economy in the last 1½ years. This development is reflected in the real interest rate differentials between Israel and the US, detailed below. Furthermore, it is significant that the required steps were taken to deal with local housing prices, in such a way that the rise in prices will be slowed, and even a decline is possible to a lower level of prices.

In addition to the slowdown in economic activity, there occurred a substantial decline in the capital market derived inflation expectations for the coming year. Even after the cut in the BoI interest rate in October the real interest rate remained positive above 1%, after the capital market derived inflation expectations for the coming year fell to 1.7%. This positive real interest rate environment, which increases, as mentioned, the BoI's room for reaction, does not characterize other economies, in particular those that are experiencing a deep crisis and where the central bank interest rate remains low, and even negative. Looking forward, we estimate at least one additional interest rate cut will occur in Israel in the near term. In the event a more pessimistic scenario of a slide into a global recession occurs, then the BoI will be able to carry out a much greater easing in the degree of monetary policy restraint.

### **The degree of effectiveness of maintaining expansionary monetary policy over time: the case of the US**

An analysis of the real interest rate level (the central bank interest rate minus expected inflation) of the US over time emphasizes the importance of the prompt response of the BoI in the recovery period of the Israeli economy. Since the early 90's there have been three episodes of recession in the US in which the US Federal Reserve Bank implemented expansionary monetary policy.

The first episode came as a result of the commercial real estate crisis and the recession of the beginning of the 1990s, and it was moderate both in terms of the amount of the decline in the real interest rate and also in terms of the length of time in which expansionary monetary policy was maintained. In contrast, the second episode, which occurred as a result of the high-tech crisis, the global economic slowdown and the economic impacts of the terror attacks of September 11, 2001, was very long, continuing five years. The extended period in which there remained a real interest rate that was significantly negative in the economy contributed to the creation of asset price bubbles, and these contributed to the creation of the sub-prime mortgage crisis, and consequently because of this, the global financial crisis occurred.

Also in the current crisis the main reaction tools in the US include the monetary side. However, according to an analysis of the result, it appears the extraordinary monetary steps implemented have had limited effectiveness. It is inevitable to remember on this regard the case of Japan, which since the banking and real estate crises there in the beginning of the 1990s has not succeeded to recover, and the expansionary monetary policy there has become a fixed situation.

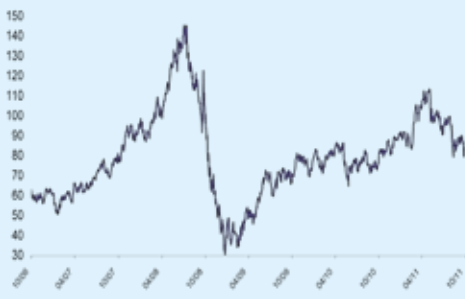
# World Macro Economic Review

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

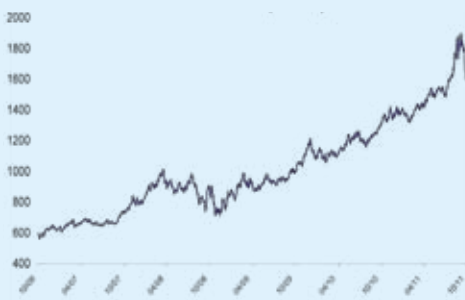
### Euro and USD vs. NIS



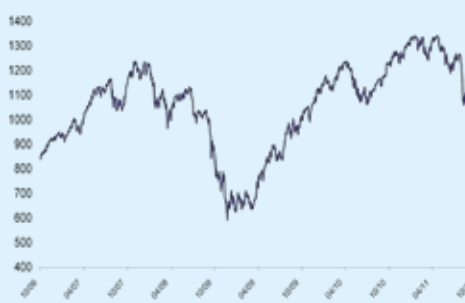
### Gold prices (USD)



### Oil Prices per barrel (USD)



### TA25



Near the end of the month (on Oct. 28, to be exact, with the approach of dawn), euro-zone leaders announced an agreement had been reached and a document was signed detailing how the continent's debt crisis would be resolved. One shouldn't dismiss the importance of this development, which faced significant hurdles, including discord and conflicts of interest between EU countries, political challenges, domestic opposition that affected the pace of progress, the political stances of various leaders, myriad procedural issues and red tape, the opposition of private-sector investors (primarily banks) to write down the value of their Greek debt holdings, all of which made the fact an agreement was finally reached an achievement of major proportions.

October also saw the publication of myriad economic updates. One of the most significant was third quarter U.S. GDP growth, which came in at 2.5%, in line with economists' expectations, but better than what some investors were fearing. It's worth highlighting that the most important source of this growth was consumer spending, which was up 2.4% year-on-year. While this was lower than historical averages, it nevertheless indicates that despite the current difficulties besetting consumers, and even if the U.S. economy's health is anything but robust, the world's leading economy is not on the cusp of a recessionary downturn.

U.S. corporate earnings season is currently under way, with 298 of the companies making up the S&P 500 index having thus far reported their third quarter results, which, on the whole, have been better than expected, including continued top- and bottom-line growth. Despite the problematic state of the U.S. economy, JPMorgan, Bank of America, Morgan Stanley and Citigroup all managed to beat analysts' consensus projections, though Goldman Sachs had disappointing results, reporting only its second quarterly loss since going public in 1999.

As for Europe, the key points of the aforementioned agreement include a bigger haircut than originally planned for private-sector bondholders of Greek debt (a 50% write-down of the bonds' face value), expansion of the European Financial Stability Facility (EFSF), the euro zone's rescue fund, to around €1 trillion, and the recapitalization of the region's banks. Moreover, Italy undertook to continue reducing its national debt, and indications were given that the European Central Bank would continue purchasing the sovereign debt of the zone's weaker members on the secondary market. According to press reports, the rescue fund will not be financed by euro-zone countries, but through the sale of insurance by the EFSF, guaranteeing the bonds of the euro-zone's member states, and through financing raised from external sources, in the private sector and from governments. The capital raised will be used to purchase the sovereign debt of euro-zone countries in both bond auctions and on the secondary market, and will also provide loans to banking institutions. Another facet of the agreement compels European banks to maintain a core Tier-1 capital ratio of at least 9% by June 2012. Banks that fail to reach this level on their own will be allowed to access funding through the governments of countries in which the banks are domiciled. Only if such assistance is denied them will they then be permitted to apply for EFSF loans. The agreement, in our view, marks a turning point in the European debt crisis. On the face of it, it offered answers to a series of questions. Would Europe's leaders be able to reach an agreement at all? Would it include adequate firepower to isolate the Greek crisis, preventing contagion from spreading to Italy and Spain? What about the fate of the continent's major banks, which hold vast amounts of peripheral-country debt? In our view, the solutions the agreement provides, even while failing to eradicate the problems entirely, at least reduce the risk that the crisis will deteriorate still further. That said, it's worth underlining that while the level of risk is now lower, a number of issues still have the power to disrupt the agreement, particularly as long as it lacks details, which are set to be fleshed out in November. Moreover, a number of weak points are evident, which will likely have to be addressed in the framework of future negotiations. All of which brings us to conclude that heightened financial market volatility is likely to continue.

# INDIA

By: **Sagit Cohen**, Economics Department, Finance and Economics Division

## Key points

- India's growth prospects are amongst the best in the world, with GDP expected to grow at a rate of 7.5% and 8% over the next two years.
- This elevated pace of growth is expected to lower India's debt-to-GDP ratio, despite the government's high budget deficit.
- Inflation in India is sensitive to commodity price swings. The anticipated global economic slowdown over the coming two years is expected to dampen inflationary pressures, such that the country's central bank, the Reserve Bank of India (RBI), isn't expected to raise interest rates beyond their current level.
- India's banking system is stable. The average capital adequacy ratio of local banks is robust. Moreover, the introduction of regulatory changes is expected to reduce risk still further.

Population (2010)	1.17 mil
GDP (2010) GDP per capita (2010)	\$1.63bn \$1,371
CDS (most recent)	213.2 basis points
Credit rating (S&P)  Dec. 2010 update	In forex: BBB- In local currency: BBB-  Outlook: Stable
Credit rating (Moody's)  Aug. 2011 update	In forex: Baa3 In local currency: Ba1  Outlook: Stable

## Economic strengths

Fast-paced economic growth; a competitive private sector; and a high savings rate, which enables the government to raise capital on India's financial markets.

## Economic weak points

A low standard of living; an overall low level of human capital; poor infrastructure; high levels of debt compared to countries with similar credit ratings; a cumbersome bureaucracy; public sector inefficiencies; and inflation characterized by high sensitivity to commodity price fluctuations.

## Macroeconomic developments

In July 2010, Moody's upgraded India's credit rating to Ba1, reflecting an outlook of fast-paced economic growth that

should enable the country to reduce the level of its national debt (see accompanying tables). India's demographics support a hefty private savings rate, which should allow the government to raise capital on local financial markets.

Inflation has exceeded the RBI's target, even after the range was lifted to 7% - 8%. Over the past twelve months to Aug., inflation stood at 8.9%, and the outlook for full-year 2011 is 10.6%. As can be seen from the diagram, inflation isn't merely a consequence of rising food prices. Prominent amongst other factors responsible for higher inflation is the rising price of metals, which increases local production costs.

As a result, the RBI has been hiking its key policy rate (most recently in late October), but the deteriorating situation in Europe has lowered economists' expectations for additional rate hikes going forward.

Exports soared by 40% in Q1 2011 compared with the year earlier period, while imports were up 23%. Hence, despite a slowdown in global trade, a relatively subdued 2.2% current account deficit is expected for full-year 2011. With the rupee depreciating modestly, the RBI has refrained from intervening in India's foreign currency market.

The next national elections are scheduled for 2014, and observers expect the current government to ride out its full five-year term, despite the ruling party's sharp drop in popularity. High levels of inflation, and rising food prices in particular, have led to protests, which quickly transitioned into a campaign against government corruption, particularly in light of the recent scandal surrounding the sale of mobile phone licenses. The country's second largest political party hasn't been able to exploit the situation to its advantage, seeing that two of its members were recently arrested for alleged bribe taking; moreover, the party's leadership is unstable.

## Banking system

The country's banking system is stable, with an industrywide average capital adequacy ratio of 14%, Tier-1 capital of 10%, and loan issuance based on retail deposits.

The asset quality of India's banks is high, and the banking sector has been implementing regulatory directives aimed at reducing both liquidity and macroeconomic risks.

Stress tests conducted a year ago indicated that even if non-performing loans doubled, the banking sector's capital adequacy ratio would remain within minimal regulatory requirements.

2013F	2012F	2011E	2010e	2009	2008	
8.1	7.5	7.8	10.1	6.8	6.2	GDP (% change)
7.1	8.6	10.6	12.0	10.9	8.3	CPI inflation (% average)
-7.2	-7.3	-7.7	-8.4	-9.1	-7.0	Govt. balance (as % of GDP)
60.9	62.0	62.4	64.1	69.4	73.1	Govt. debt-to-GDP (%)
-1.9	-2.2	-2.2	-2.6	-2.8	-2.0	Current account (as % of GDP)

Source: International Monetary Fund (Sept. 2011, updated forecast)

This survey is based on forecasts and data compiled from the International Monetary Fund, The Economist Intelligence Unit, and Moody's.

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