



Private Banking
Issue No. 72
January 2009

INVESTOR'S REVIEW

ESPECIALLY FOR LEUMI UK PRIVATE BANKING CLIENTS

Macro Economic

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What's in "Investor's Review"

- Macro Economic Review
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The composite state-of-the-economy index fell 0.4% m/m in November

The composite state-of-the-economy index (also known as the S-index) fell 0.4% m/m in November, while year to date the index has increased 2.5%. As is commonly known, the composite index reflects business sector activity in Israel. A look at the components of the index shows that industrial production has displayed a downward trend in recent months. This is apparent when analyzing overall production, and also when looking at production excluding the high-tech segments. Developments in local employment (salaried positions) also indicate a drop in activity. This all points to the decreased demand for Israeli production for the local as well as the export markets, as seen against the backdrop of the global financial crisis. Proceeds in the trade and services sectors also show a decline in activity in recent months, with notable negative trends evident in both the wholesale trade sectors as well as the food and hospitality services sectors. This is a result of the slowdown in private consumption in the economy; furthermore, sales at retail chains also indicate a slowdown (although currently not a decline). The sectors mentioned above account for a substantial amount of business sector activity; therefore, the change in the trend of their activity in recent months, from a slowdown to an actual decline in activity, does not bode well for the Israeli economy in the near future.

What can we learn from previous periods in which there was a decline in the composite index?

As already mentioned, the decline in the composite index indicates a slowdown in overall business sector activity, while in certain segments there was an actual drop in activity. It is important to note that the composite index has now fallen in four consecutive months, a span the length of which was last seen only during the recessionary period of 2000-2003. What the data indicate is that during periods of decline in activity of more than four months, in most cases the decline lasted for more than a year (16 months on average). Furthermore, the duration of periods of decline ranged from 8-28 months. This is not encouraging news at all, indicating that the current decline may not be brief at all.

The Bol cuts the interest rate to a low of 1.75%...

On December 29, the Bank of Israel (BoI) announced a 75bps cut to its interest rate for January 2009, to 1.75%. The central bank cited among its reasons for the cut the declines in inflation forecasts, both those derived from capital market data (in December the forecasts were -0.85% for the coming year) and those from private forecasts (0.5% for the coming year). In the event these forecasts become a reality, 2009 will be the fourth year in a row in which the price stability target range is not achieved. In addition, the BoI noted the deterioration in the state of the economy – fourth quarter data indicated a slowdown, and perhaps even a decline in economic activity.

Indicators from the labor market also showed weakness. Additionally, the Bank noted the negative global economic data and the belief that the International Monetary Fund (IMF) will lower its global growth expectations in January. All of these conditions led the BoI to implement a sharp interest rate cut, in an effort to support real activity in the economy and to help the economy cope during this period of global crisis.

Select Indices

	Rate	Return in % December	Return in % 2009
TA 100	604	-4.87	5.34
TA 25	689	-1.90	3.83
DOW JONES	8,953	-0.60	2.01
NASDAQ	1,628	2.70	3.23
NIKKEI 225	9,081	4.08	2.07

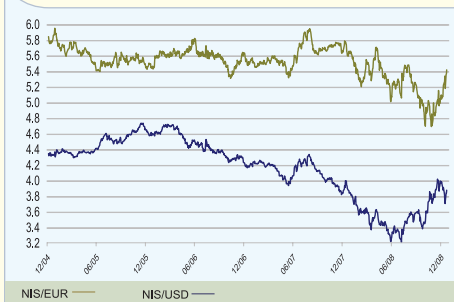
Correct to 05.01.2009

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World Macro

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Euro and USD vs. NIS



TA25



Oil Prices per Barrel (USD)



Gold Prices (USD)



2008 was a year of change. It began with the US financial system but spread throughout the global economy. Fear was one of the predominant characteristics of the year, manifesting itself in historically high volatility levels in all assets. After several years of global growth, accompanied by price increases and declines in risk premiums, the change was especially painful.

Economic forecasts for 2009 are quite gloomy. The slowdown in world economic growth is expected to continue and negative growth rates are forecasted for several developed countries. A considerable decline in personal consumption is expected in the US, which will have a significant negative influence on growth; moving in the other direction, government spending will be the main positive contributor. The a-bit-too-late and definitely-not-enough effort taken by the Bush administration to support the battered housing sector and the frozen MBS market means that during 2009 these issues will continue to be the major risk factors for the global economy. As long as the free fall in the housing sector continues, the "true" value of mortgage backed securities remains in question. As long as this market is frozen, quoted prices will remain panic driven. While these phenomena persist, additional writedowns might be required; the financial institutions holding these assets will continue to hoard cash, their willingness to extend credit will be minimal and the influence on the global economy will continue to be severe.

During 2008, inflation was considered one of the main risks to stability. This seems to have abated and now prices are declining, a trend which will probably stay with us during the first half of 2009. This trend is expected to subside as the effect of lower commodity prices diminishes. Nevertheless, the risk of price declines during the 2nd half is real, as a result of lower demand levels. In view of these developments and the Fed's commitment to supporting growth, the US monetary interest rate is expected to stay at a low level. The US and Japan were the first to reach a 0% interest rate environment, but we expect others to follow suit. In the Euro Zone, policy makers have been hesitant to lower interest rates, probably due to fear over inflationary pressures in the medium term, and seem reluctant to breach the 2% level. Nevertheless, we believe the economic reality will cause interest rates in that area to be lowered in the coming months.

2009, as opposed to previous years, will probably bring to light differences among emerging markets. Like developed countries, they are all expected to register a slowdown in economic growth. But greater weakness will be displayed by those most dependant on exports, in particular of commodities, and by those who did not utilize the fruits of past years' windfalls to strengthen their ability to withstand a global crisis like the one we are experiencing today.

Stock markets are expected to enjoy positive sentiment at the beginning of 2009, due to government change in the US, as well as when the first signs of improvement in the real economy appear, likely towards the end of the year.

In view of expectations for a low interest rate environment, yields will probably continue to decline in the near future. In the US, where yields have already tumbled to historically low levels, there is less potential for further declines. Declines will probably occur if extreme fear again plagues the markets. However, we believe that present yield levels already represent a considerable degree of fear and risk aversion and any slight improvement in sentiment will likely result in a rise in yields.

The volatility that resulted from the uncertainty and anxiety that prevailed during 2008 will in all probability continue to characterize investor sentiment during 2009. We remind investors that sentiment usually has a crucial impact on short term market behavior. Therefore, we advocate caution.

Government Bond Yield Spreads in the Euro Zone

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

Up until mid-2007, bonds of the various Euro Zone countries were traded with similar yields, while the different credit ratings and risk level differences between the countries were hardly priced. Thus the yields of German and Greek government bonds were similar, despite the fact that Germany is the strongest and largest economy in the Euro Zone with a GDP of \$3.3 trillion, a budget deficit of 0.2% of GDP and the highest possible credit rating of AAA, compared with Greece, which has a GDP of \$360 billion, a budget deficit of 2.8% of GDP and an A credit rating.

However, the credit crisis that broke out in mid-2007, resulted in a re-pricing of risks and an opening of yield spreads between the bonds of different Euro Zone countries. We believe that we have gone from one extreme to another, in that currently, substantial yield spreads have grown between German government bonds (which constitute the European benchmark) and those of other Euro Zone countries, even those with AAA credit ratings.

There are 16 countries which issue their bonds in euros and, therefore, a transition between bonds issued by these various countries does not involve any currency risk. All that remains to consider is the risk of the relevant governments not being able to meet their commitments to the bondholders.

The accompanying table presents the ratings and GDP data for the 16 countries that constitute the Euro Zone. As can be seen in the following table, apart from Germany, there are another seven AAA ranked Euro Zone countries: France, Spain, Holland, Austria, Ireland, Finland and Luxembourg.

During periods of an economic slowdown, investors tend to prefer investment in low risk assets, preferably government issued bonds of developed countries with large economies. The macro economic data can testify whether the yield differences between the government bonds are justified. The following table includes a few economic indicators which give an indication as to the country's economic stability.

It is evident from the table that every one of the countries has violated at least one of the Maastricht Treaty criteria, but still, the economic makeup of both France and Holland is not worrying and the possibility of a rate cut or a default is extremely low.

We reiterate that, to one degree or another, most European governments have been forced to aid their local financial system, and might still do so in the future. This assistance will probably lead to increased budgetary deficits in the various countries and, in some cases, deficits breaking through the threshold of 3% of GDP. The German government has

approved a €480 billion aid package, of which €80 billion has been infused directly into the banks, to deal with the credit crisis in the country. The French government has approved a €265 billion aid package, of which €10.5 billion will be a direct capital infusion into six of the country's largest banks. The Dutch government is providing aid of €200 billion to the financial sector, in addition to the €16.8 billion that was allocated for acquiring the Dutch operations of the Belgian financial group, Fortis.

Despite the expected increases in government deficits, we are convinced that this does not present any real threat that any of the AAA rated Euro Zone countries will reach a state of bankruptcy.

We currently believe that despite the sharp yield declines in the Euro Zone government bonds during recent months, there is still some potential for further yield declines. Such declines would express the intensity of the economic crisis in the Euro Zone and the possible additional ECB interest rate cuts.

It should be noted that the option of changing between the various bonds is intended for those who already hold bonds denominated in euros in their investment portfolios, and does not constitute a recommendation for the Euro as a currency.

Country	S&P Credit Rating	2007 GDP (\$ Billions)
Germany	AAA	3,297
France	AAA	2,562
Italy	A+	2,107
Spain	AAA	1,429
Holland	AAA	754
Belgium	AA+	449
Austria	AAA	377
Greece	A	360
Ireland	AAA	255
Finland	AAA	246
Portugal	AA-	220
Slovakia	A+	75
Luxembourg	AAA	48
Slovenia	AA	45
Cyprus	A+	21
Malta	A	7

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