Terrorism, Security Threats and Israeli Stock Market Volatility

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The tragic kidnapping and murder of three Israeli teens by Palestinian terrorists and the shocking retaliatory kidnapping and murder of an Arab teen by Israeli extremists ignited the latest round of violence in the Palestinian-Israeli conflict. On June 12th Israel launched Operation Brother's Keeper to locate the kidnapped boys and, as Hamas responded with rocket fire from the Gaza Strip, Israel ordered airstrikes against Hamas (Operation Protective Edge). This spate of violence comes in the wake of failed peace negotiations in April.

Once again the central impediment to peace is whether Palestinians displaced by the 1948 War of Independence and their descendants have a "right of return" to Israel. The Palestinian leadership contends this right of return is sacrosanct and non-negotiable while Israel argues that granting millions of Palestinians residency and/or citizenship within Israel's borders would transform Israel into a majority Arab and Muslim country. Of course, this would destroy the very essence of Israel as a sovereign safe-haven for the Jewish people and risk potential ethnic cleansing of Jewish Israelis. One need only glance at the sectarian violence among Arabs in Syria and Iraq to understand Israel's legitimate concern. While other impediments are also important including Palestinian disdain for Israeli settlement policies in the West Bank and the permanent status of Jerusalem, only the "right of return" issue entraps Israelis and Palestinians in permanent conflict.

While financial markets are often derided as irrational and short-term oriented, in fact, they can often prove startlingly wise in their forecasts. Rather than experiencing extreme volatility in reaction to each new round of conflict, violence, provocation or military encounter the Israeli stock market tends to react quite modestly to security related episodes and usually recovers rapidly. This is not because stock market investors regard security issues as unimportant. Rather investors most likely regard security threats as a permanent variable in the Israeli financial equation. As such, Israeli stocks tend to trade at valuation discounts relative to the United States.

Chart 1

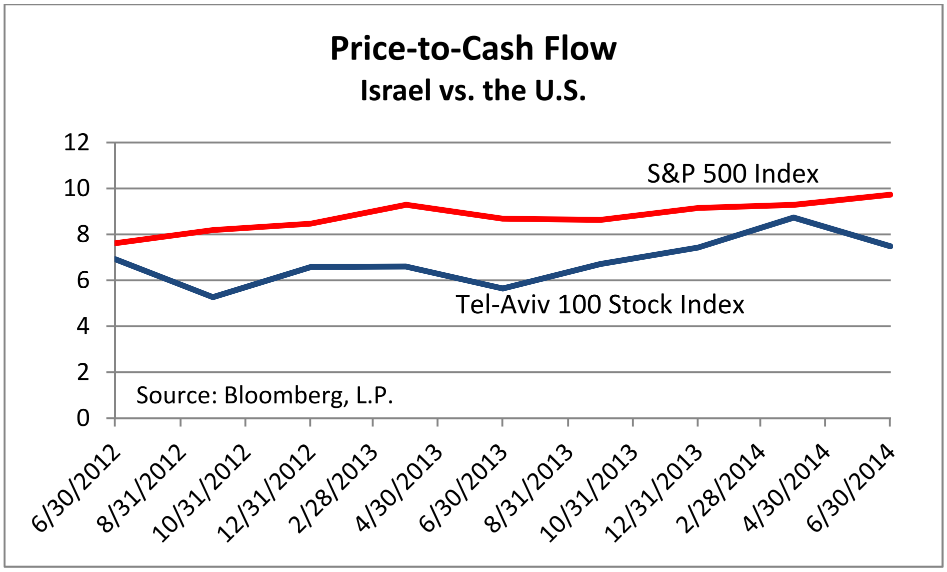


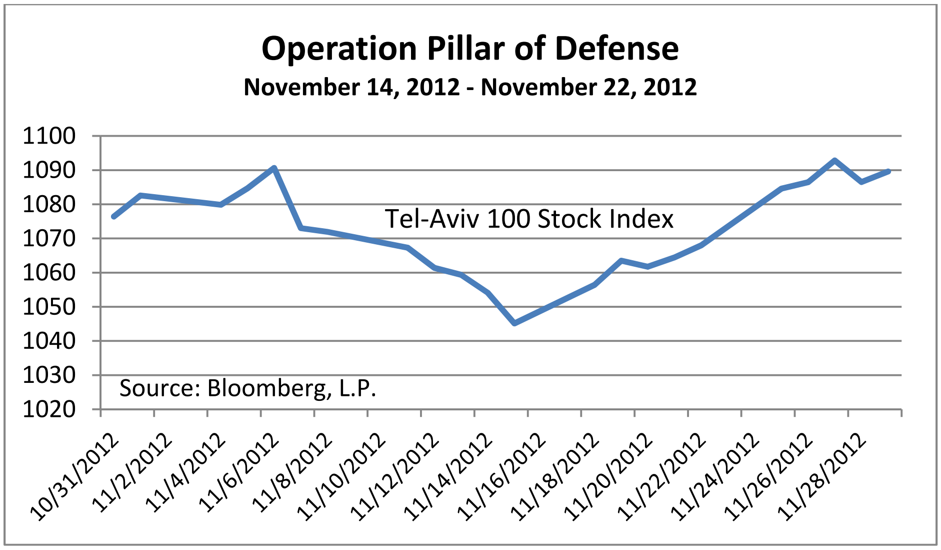
Chart 1 highlights the Price-to-Cash Flow Ratio for the Tel-Aviv 100 Index relative to the S & P 500 Index over the past two years. At present, Israeli companies listed in Tel-Aviv sell for 7.5 times cash flow while U.S. stocks trade for 9.7 times cash flow. In other words, Israeli stocks are currently valued at a 23% discount to U.S. stocks. This valuation discount predates the current cycle of violence and includes the calmer period during the recent peace negotiations. The discount is even more striking given Israel's more rapid economic growth both recently and over the past 15 years. Of course, the standard economist's caveat of "all things held equal" must be invoked, because many factors impact valuations. It certainly seems logical however, that Israel's volatile security situation is a significant and constant risk factor for investors.

Lower valuations help make Israeli stocks a good deal. While many investors fret and avoid investing in the Israeli stock market, they are just creating opportunities for those of us less afraid to commit our capital. Terrorism and armed conflict certainly impact the Israeli stock market. Since the commencement of Operation Protective Edge the Israeli stock market dropped 2.5% and since the collapse of the peace process in April the market is down about 5%, but history provides encouraging examples during previous military conflicts.

Operation Pillar of Defense

Israel launched Operation Pillar of Defense in November 2012 to deter increased rocket attacks from the Gaza Strip. As you can see in Chart 2, the Israeli stock market dropped in early November as rocket fire intensified and bottomed shortly after Israel launched its operation on November 14, 2012. The market ultimately returned to its pre-crisis level just three weeks later.

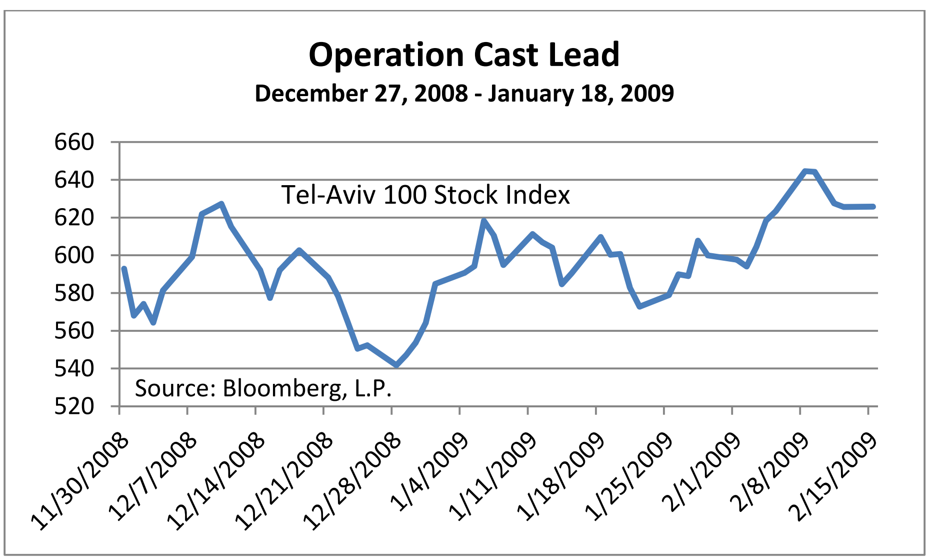
Chart 2



Operation Cast Lead

Operation Cast Lead in December 2008 and January 2009 was a much more significant military engagement that included both air strikes and ground incursions. As you can see in Chart 3, the Tel-Aviv 100 Stock Index declined approximately 14% as rocket fire intensified but also bottomed the day after Operation Cast Lead began. The Israeli market recovered most of its losses prior to the operation's conclusion on January 18, 2009 and ultimately hit a new high in early February.

Chart 3



Volatility is modest because security is a permanent risk factor

Until either the Palestinians or the Israelis change their minds about the Palestinian demand for a "right of return" or the nature of Israel as a Jewish state their conflict is insoluble. As such, investors typically demand a security discount when purchasing Israeli stocks. These lower valuations tend to mute volatile reactions to armed conflict, terrorism or geopolitical threats (i.e. the Iranian nuclear program, the Syrian civil war, the ISIS takeover of Sunni Iraq, etc.) because investors already expect problems to occur. With the recent past offering several examples – as long as Israel can defend itself against these threats – patient investors should be rewarded for their willingness to accept the greater risks.