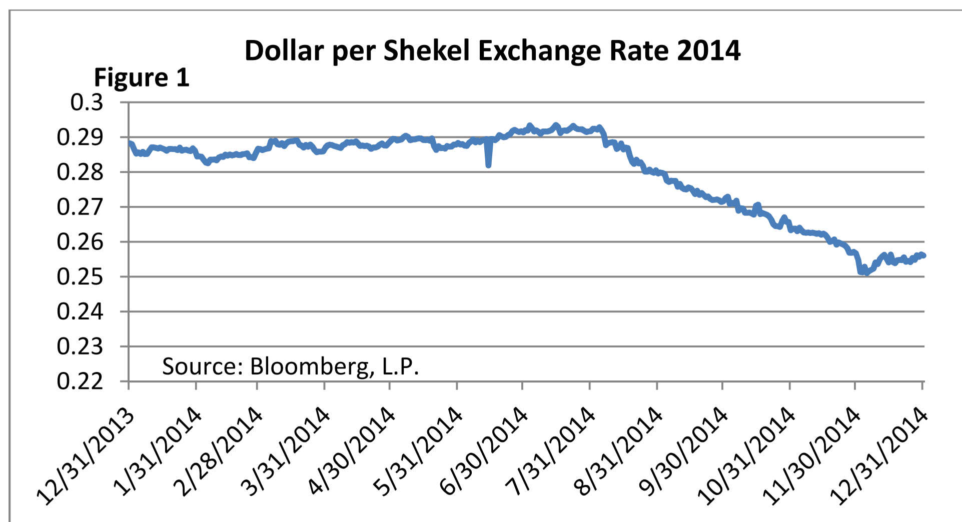
יועצי השקעות ישראל
Israel Investment Advisors

The Shaky Shekel

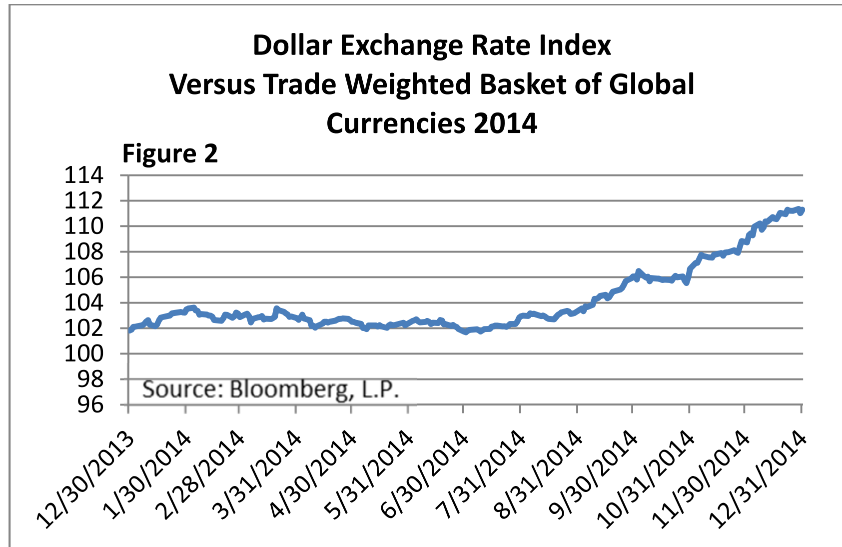
Brian J. Friedman, CFA
December 31, 2014

The booming Israeli economy hit a few speed bumps in 2014. Although the real estate market continued its frothy boom in the first half of the year, the summer conflict with Hamas in Gaza dampened activity in the second half of the year. Consumer spending dropped off during the seven weeks of conflict, and tourism was dealt a serious blow. Despite these war related economic issues, the most impactful problem was falling exports to Europe as Eurozone economies weakened. In response, the Bank of Israel (BOI) unexpectedly shifted policy and lowered its benchmark interest rate to an all-time low of 0.25%.



As you can see in Figure 1, the Israeli shekel was steady relative to the dollar for the first half of 2014, but shifted course as economic pressures mounted during the second half of the year. Ultimately, the shekel depreciated 11.2% against the dollar in 2014. Although the Israeli economy decelerated during the second half of 2014 just as the United States' economy

accelerated, Israel was not alone in the world. As can be seen in Figure 2, the dollar appreciated 9.3% relative to the currencies of America's major trading partners. Of particular concern was stagnation and potential recession in the Eurozone countries, where the euro declined 12% relative to the dollar.



Despite military conflict with Hamas in Gaza and the domestic economic pressures on tourism, consumption and construction, the biggest short-term economic problem facing Israel is the weakness in the Eurozone countries. The shekel essentially ended 2014 flat relative to the euro as both Israel and Europe weakened together.

Israel is a small trading nation where exports account for about 33% of Gross Domestic Product (www.worldbank.org). Although trade is robust with the United States and is rapidly growing with Asia, Europe is Israel's largest trading partner. Israel needs a healthy and vibrant Europe to maintain its own economic vigor (as does the rest of the world economy).

If European economies slide further then Israel will also weaken, but only to a certain extent. Israel still has a number of other economic engines to rely upon. As we have discussed in other letters, Israel is engaged in a significant restructuring of its domestic economy, its banking system is relatively healthy and the real estate market is cooling but not crashing. Most of Israel's exports are high value added and remain in demand in the United States, Asia and many emerging markets. Economic growth in America – Israel's 2nd largest trading partner– is accelerating.

Despite its depreciation in 2014, the shekel is trading within its recent historical range. If the Israeli economy weakens further while the United States continues to strengthen then the

shekel could depreciate more. Over the long-run, however, Israel retains high growth potential – perhaps in the 4% to 5% per year range – ultimately placing a floor under the shekel's depreciation.

Meanwhile, our diversified portfolio contains companies that benefit from the dollar's strength as well as those that are harmed by shekel weakness. Most of them, however, require economic strength in their core markets of Israel, Europe and the United States. Domestic economic activity in Israel is stabilizing after last summer's conflict, the U.S. appears to be accelerating, but Europe remains problematic. Fortunately, policies are shifting in Europe toward stimulating economic growth with monetary policy and structural reform. Despite our optimism about Israel's long-term future, in the short-run we also need to pay attention to Europe. European countries cannot be written off as "old world" declining powers, Israel and the world still need a healthy and prosperous Europe for our own long-term prosperity.