War Has Come, but Israel is Strong and Resilient

Brian J. Friedman, CFA
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Starting in the early hours of Saturday morning, October 7th, during Shabbat and Simchat Torah, Hamas perpetrated the worst terrorist attack in Israeli history. So far, as of this writing more than 1,200 Israelis died in the attack, over 3,200 were wounded and at least 150 held captive by barbaric criminals in the Gaza Strip. Israel is gathering forces and developing plans for its response. Prime Minister Netanyahu promises "what we are about to do to Hamas will resonate for generations." We unequivocally support Israel and are girding ourselves for the conflict's escalation. Despite obvious failures of intelligence and military defense we believe Israel must – and will – reestablish security and deterrence.

There are no excuses for this attack, no justifications, and no need to better understand Hamas' motivations. Like the Nazis before them, Hamas must be defeated. It will be very difficult since Hamas uses Gaza's civil infrastructure, including homes, schools, hospitals, and mosques as camouflage for their terrorist activities; additionally, Hamas is deeply embedded in Palestinian society. Perhaps they represent majority opinion in Gaza and maybe even in the Palestinian Authority. It does not matter. Their ideology and governance are unacceptable no matter how many Palestinians support it. We trust the Israel Defense Forces will pursue its military objectives, while adhering to its long-held ethos to minimize non-combatant casualties. Despite this commitment, we fear casualties may be very high on all sides of this war as Israel fights to defeat its enemies.

Of course, by necessity, economics will take a back seat to military considerations for a while. It is important to remember, however, that Israel's superior military capabilities rest upon an advanced economic foundation which undergirds Israel's expensive military assets. Following this attack - in the days, weeks, months, and years ahead - Israel will plug the glaring defense gaps revealed by this heinous attack. This effort will necessitate continued economic growth and prosperity, likely motivating accelerated economic reforms.

Israeli society is incredibly resilient, including its business sector. The Tel-Aviv 125 Index initially fell 6.7% on its first day of trading following the attack. Since then, it has traded slightly higher. The shekel declined to 3.96 to the dollar but fell less than expected given the gravity of the situation. I wrote the text of this newsletter before October 7, 2023, but the argument still holds. The months ahead will be trying but Israel, as a country, entered this conflict as an undervalued asset. I believe those invested in Israel will prosper as Israel prevails.

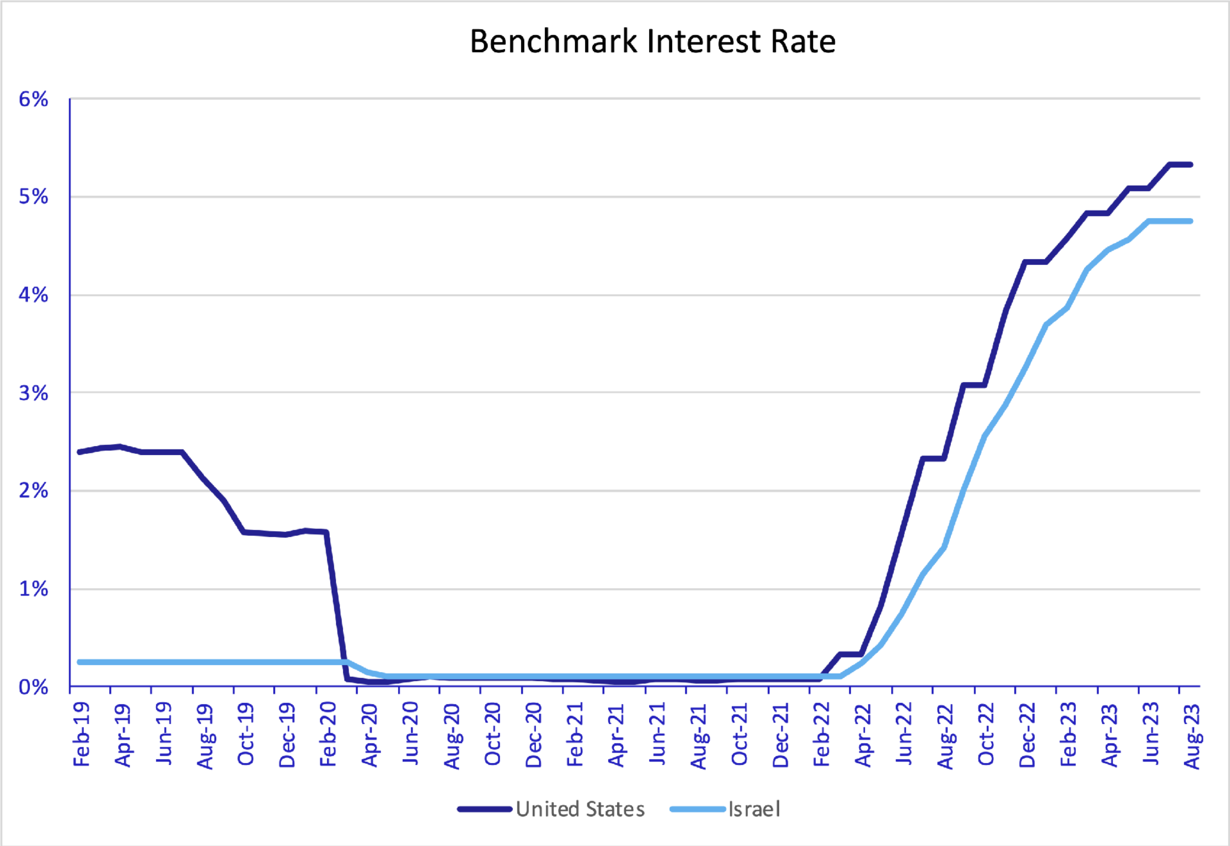
We extend our deepest condolences to the families who have lost loved ones; may their memory be for a blessing. We wish Refuah Shlema (complete recovery) for those who have been injured, and we pray for the safe return of every hostage and every soldier defending the State of Israel.

The Weak Shekel is Our Problem…But Not Forever

In our **4th quarter 2018 newsletter** we wrote: "If world financial markets were the solar system, the U.S. dollar would be the sun, whose immense gravity controls the orbits of other national currencies. Just as the sun burns its fuel, the dollar is fueled by interest rates on U.S. treasury bonds. Higher U.S. interest rates relative to other countries cause the dollar's sun to burn brighter, sometimes scorching fragile financial systems." In January 2022, the U.S. Fed Funds interest rate was 0%. After 11 interest hikes the Fed Funds now hovers between 5.25% and 5.50%. The impact on the Israeli shekel has been dramatic. The exchange rate plunged 20% from 3.1 shekels per dollar on January 1, 2022, to 3.8 shekels per dollar on September 30, 2023.

Bank of Israel interest rate hikes, while pronounced, have lagged the U.S. Federal Reserve. As displayed in Chart 1, the Bank of Israel raised its policy rate (the Israeli equivalent to the U.S. Fed Funds interest rate) from near zero in early 2022 to 4.75% now. Israeli interest rates below American interest rates exert downward pressure on the shekel since cash deposits earn more in the U.S. In recent months U.S. deposits are even more attractive since inflation in Israel and the U.S. are now running apace.

Chart 1

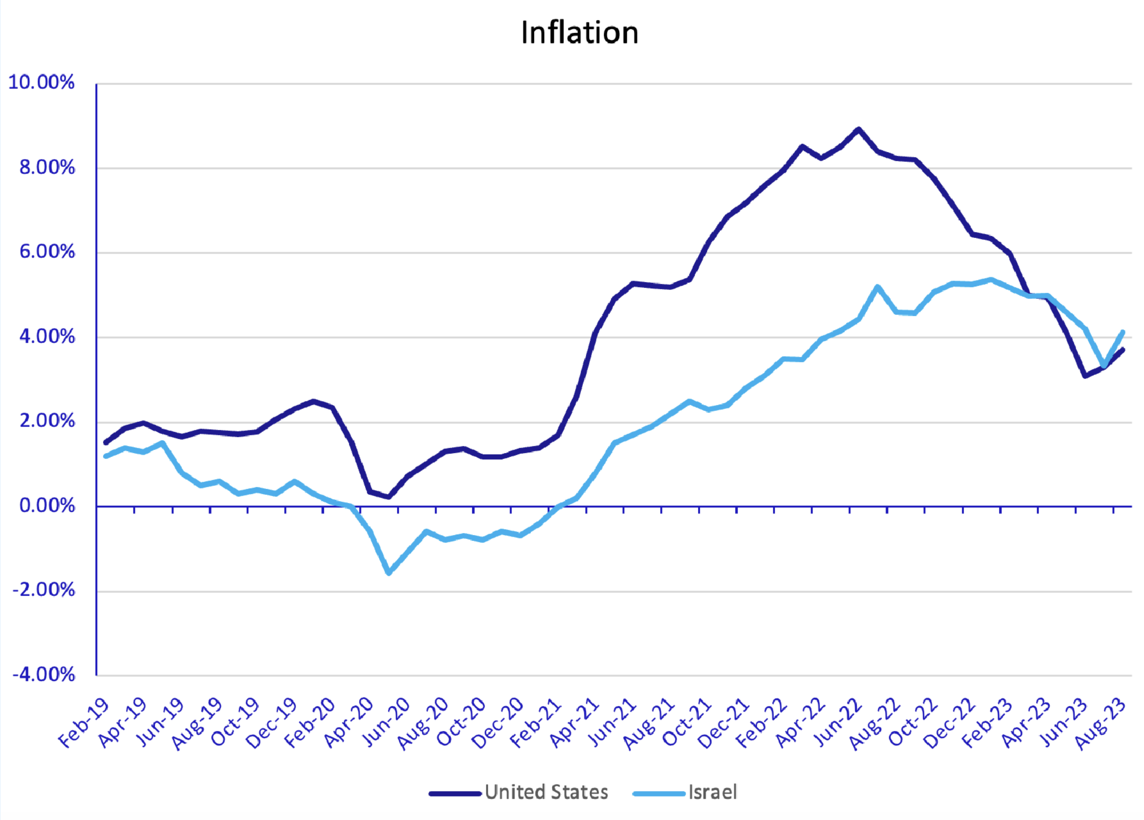


Sources: FactSet Research Systems, Inc.

Inflation is Decelerating in the U.S. and in Israel: A Good Omen for the Shekel

As you can see in Chart 2 (next page), the post-pandemic inflation rate in the United States peaked at 8.9% in June 2022. Inflation in Israel did not accelerate as rapidly during this period but reached its peak rate of 5.4% about six months after the U.S. inflation rate had already climaxed. By this time the U.S. inflation rate was decelerating faster, converging with the Israeli inflation rate by Q1 2023. With similar inflation, but higher interest rates, America became a more attractive destination to park cash. Tighter monetary policy in both countries should continue to squeeze inflation lower. In Israel's case, interest rates may rise further until they reach parity with the United States.

Chart 2



Source: FactSet Research Systems, Inc.

Judicial Overhaul Turmoil Contributes to the Weak Shekel, but is Difficult to Quantify

Given the recent political turmoil in Israel, it may surprise some of our readers that the Tel-Aviv 125 Index is only down by 8.9% between January 1,2022 and September 30, 2023 when valued in shekels. The decline is a much more significant -26.1%, however, when translated into dollars (see Chart 3). This reflects the continued resilience and strength of the Israeli domestic economy and robust corporate earnings, while the shekel is more heavily influenced than the stock market by global interest rate differentials.

Chart 3

Global Stock Index Performance 12/31/2021 - 09/28/2023

Index	Currency	Performance
Tel-Aviv 125 Index ILS	ILS	-8.9%
Tel-Aviv 125 Index USD	USD	-26.1%
S & P 500 Index	USD	-7.4%
Nasdaq Composite Index	USD	-14.9%
MSCI Europe, Australasia, Far East Index	USD	-7.6%
MSCI Emerging Markets Index	USD	-18.3%

Source: Bloomberg, L.P.

Although the shift toward higher interest rates is the dominant factor for shekel traders, the judicial reform controversy is also playing a role. While difficult to quantify, Chart 4 highlights that the shekel weakened more than many other developed currencies. Higher interest rates and the judicial overhaul debate present headwinds for American investors in the Israeli stock market, but the interest rate issue will likely dissipate as we approach peak interest rates, particularly if inflation in both countries continues to decelerate in tandem. Resolution to the judicial reform controversy could further boost the shekel, but the current lack of resolution is probably already reflected in the shekel exchange rate.

Chart 4

Global Exchange Rates vs. the U.S. Dollar 12/31/2021 - 09/28/2023

Currency	Devaluation (%)
Israeli Shekel	-19.2%
Canadian Dollar	-6.3%
Euro	-7.1%
U.K. Pound	-10.0%
Australian Dollar	-11.5%
Swedish Krona	-17.1%
Japanese Yen	-22.9%

Source: Bloomberg, L.P.

Israel as a Country is Now an Undervalued Asset

As we wrote in our valuation note in May 2023: "Israeli company valuations are quite low at the present time. We cannot predict how and when recovery will occur, but we believe the current economic and political turmoil presents significant investment opportunity for investors with a long-term horizon. Over the past five years the Earnings per Share (EPS) for both the Tel-Aviv 125 Index and the Bluestar Israel Global Index more than doubled. The Israeli Indexes now trade at a substantial discount to American stocks represented by the S&P 500 Index despite their faster earnings growth." From an American perspective, valuations are even lower given the substantial drop in the shekel to dollar exchange rate. As a result of the sizeable decline in the shekel, we believe that Israel as a country is an undervalued asset with even more motivation to recover from this sudden war and to prosper in the coming years.

We recognize that you may have questions about the dynamically changing circumstances. Feel free to submit questions to Brian.

For more information contact:
Amy Kaufman Director, Investor Relations
303.861.3798 | akaufman@israelinvestmentadvisors.com
www.israelinvestmentadvisors.com

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