Israel Is Not Immune From Global Turmoil

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Israeli stocks did not escape the global financial turmoil during the second quarter of 2022, but Israel's circumstances differed from other countries. Indeed, the downturn in Israeli stocks was less than it might have been, thanks to such factors as the avoidance of a tech bubble, Israel's disciplined monetary and fiscal policy, and the resilience of the shekel.

In the United States, for example, a wide variety of high-flying technology stocks reached bubble proportions during the pandemic, only to fall back to earth in recent months. The Nasdaq Composite Index, where many of these stocks trade, is down 31% from its peak through June 30, 2022. While a few Israeli stocks participated in the bubble, most did not.

Israel Is Raising Interest Rates More Slowly than the United States

To counteract pandemic economic dislocation, the U.S. government injected $6 trillion of fiscal support into the American economy, almost 1/3 of Gross Domestic Product (GDP). The Israeli government was considerably stingier. The U.S. Federal Reserve also stepped on the gas pedal, cutting interest rates to zero and flooding the financial system with money. Amir Yaron, Governor of the Bank of Israel (BOI), followed suit with 0% interest rates but substantially less total monetary stimulus. With less money flowing through its financial system, Israel's inflation rate was 4.1% over the past 12 months, still too high, but less than half of the 8.6% inflation rate in America.

In 2022, the U.S. reversed course, ending fiscal support programs and raising interest rates. While these policy reversals immediately rattled financial markets, it will take several quarters for the inflation rate to decelerate markedly. The BOI also raised interest rates, but more slowly than the Federal Reserve. The BOI benchmark interest rate is now 1.25%, contrasted with 1.75% for the U.S. benchmark Fed Funds rate.

Our Fund Is Affected by Declining Stocks and a Weaker Shekel

In a small country like Israel, Governor Yaron must pay significant attention to the shekel exchange rate. As we discussed in several previous letters, the shekel strengthened against the dollar over the past 12 years. One of very few world currencies to do so. While the long-term fundamentals supporting shekel strength remain intact, the BOI is not averse to a modestly weaker shekel in the short term. A softer shekel allows Israel's export-oriented economy to remain competitive in a weaker global environment.

These differences explain why the Tel-Aviv 125 Index declined 10.2% during the quarter when measured in shekels but by a more pronounced 17.7% when translated into dollars. For comparison, the S&P 500 Index fell 16.1% during the second quarter. Of course, as American investors, our bottom-line returns are measured in dollars. While the shekel has appreciated 8.4% since we started the Israel Investment Fund, L.P. In August 2010, this is the third time we experienced a significant interim reversal.

Each shekel exchange rate reversal was triggered by global macroeconomic events rather than Israel-specific circumstances. In 2011 and 2012, the shekel declined 18% during the euro debt crisis. In 2014, the shekel depreciated 16% as the U.S. Federal Reserve ended Quantitative Easing and declined 10% in 2018 as the U.S. raised interest rates. After each of these declines the shekel ultimately recovered or exceeded former highs once the global situation stabilized.

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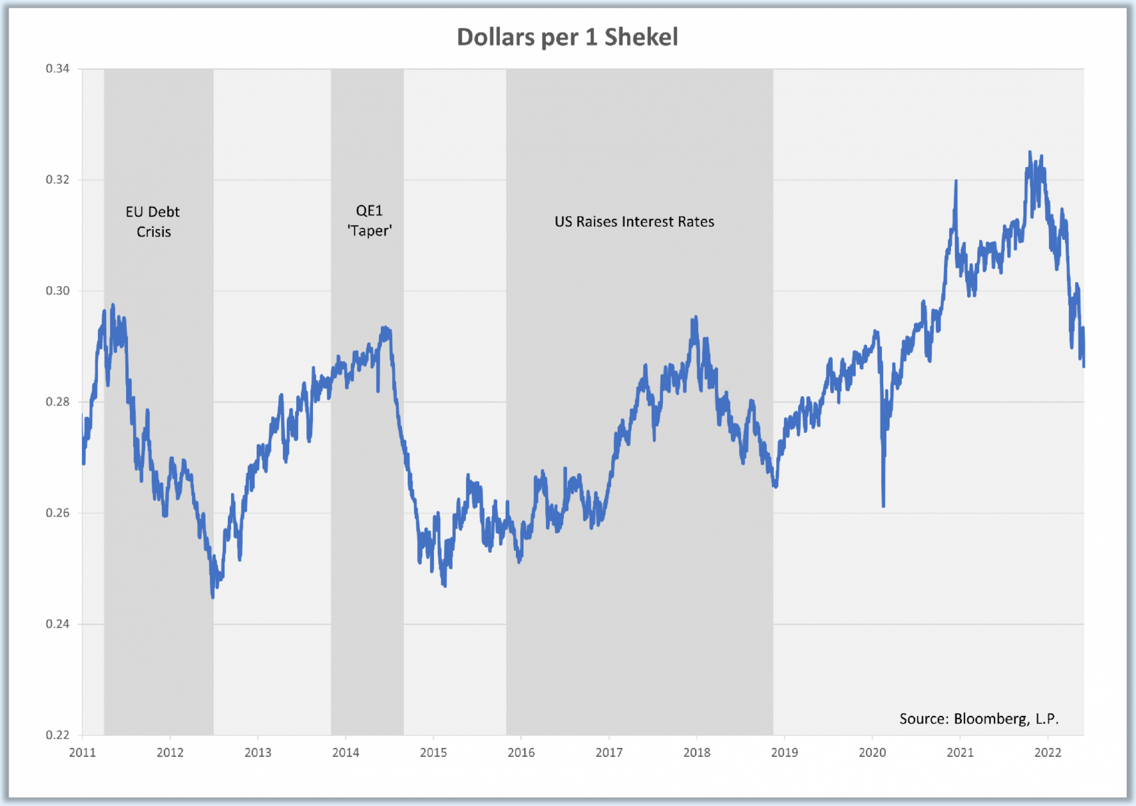

Israel's Strong Long-Term Fundamentals Remain Intact

We have discussed Israel's economic fundamentals relative to the United States many times in our quarterly letters. As we have noted in detail in earlier letters, faster economic growth, faster population growth, a current account surplus oriented toward high-value technology exports, disinflationary government policies, and substantial reductions in imported energy due to new domestic natural gas reserves all contribute to the upward trajectory of the shekel in the long run. While interim reversals are painful in the moment, they often enable Israel to achieve more stable and balanced subsequent economic growth.

Israeli companies and the Israeli economy are not immune from global economic turmoil. Like other currencies, the shekel is particularly sensitive to changes in American monetary policy. Nonetheless, despite the current downturn, the underlying strengths of the Israeli economy offer reassurance that our portfolio remains well positioned for the long term.

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