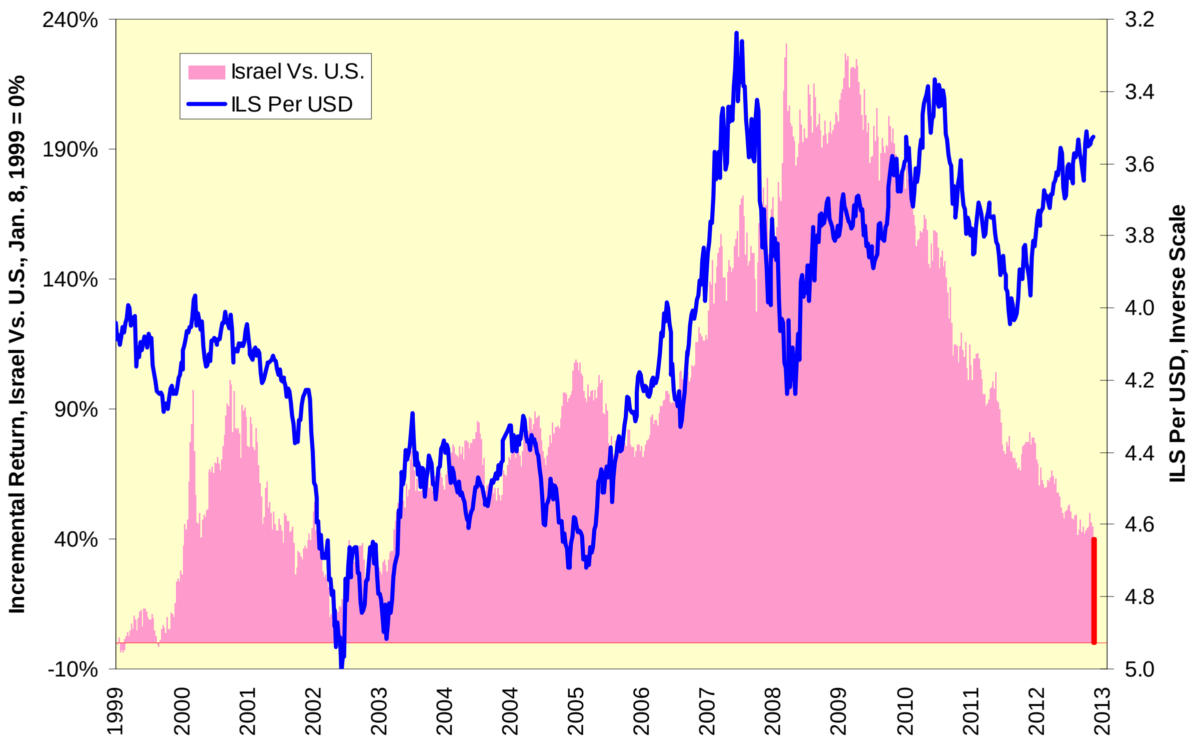
Israeli Stocks Sidestep The Shekel

The recent executive suite turmoil at Teva Pharmaceuticals (TEVA) underscored a couple of issues, such as maintaining operating margins in the generic pharmaceutical business and how all intellectual property businesses are at massive risk of executive missteps. Teva is the largest holding of two major ETFs investing in Israeli stocks, Market Vectors Israel ETF (ISRA) and iShares MSCI Israel Capped ETF (EIS).

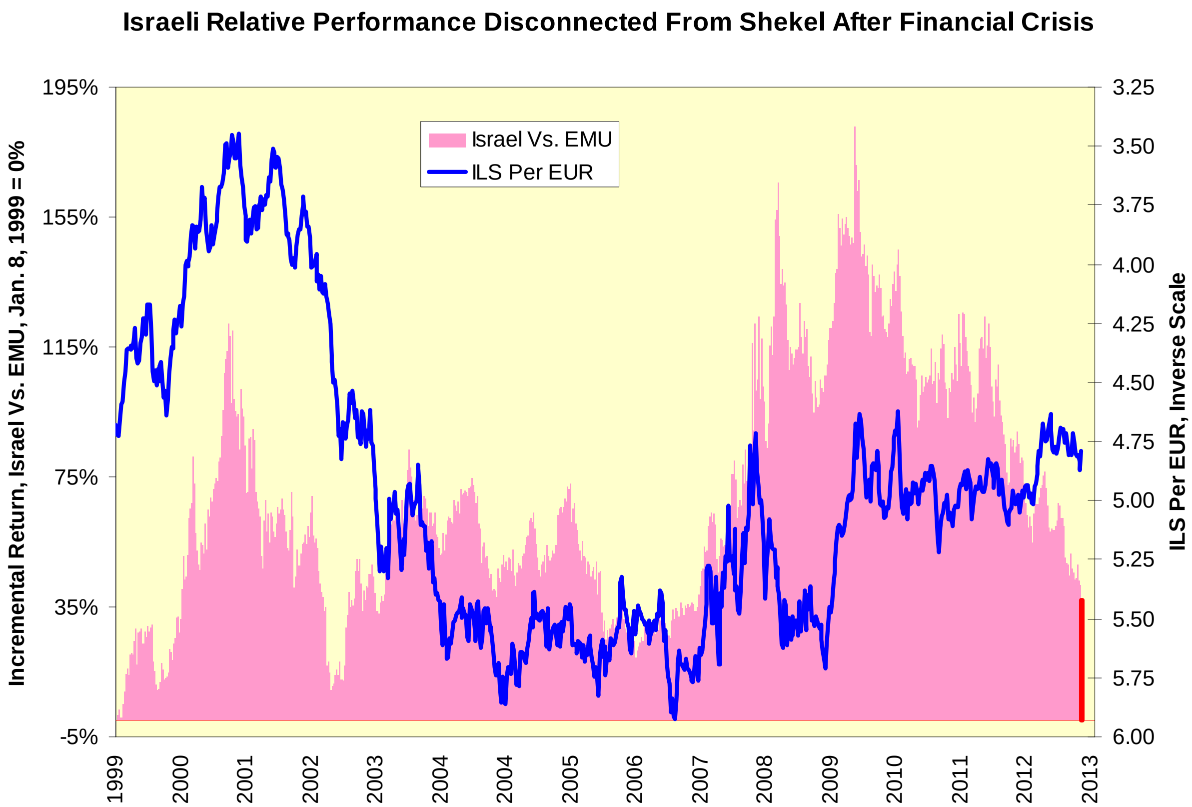
Both of these ETFs are priced in U.S. dollars, but should be affected by the exchange rate of the shekel (ILS), not only against the USD but against the euro as well. As the U.S. short-term interest rate curve has been persistently steeper than its Israeli counterpart since QE3 began in 2012, the ILS has gained on the greenback while it has weakened against the euro. Just like a planet orbiting two stars, an actual occurrence, currencies such as the ILS and the Turkish lira figuratively orbit both the USD and EUR.

However, these expected currency effects so common in a host of international markets, both developed and emerging, have dissipated for Israeli stocks. If we map the incremental total return on the MSCI-Barra Israel index to the U.S. market in USD terms, we see a weak and erratic correlation that broke after QE2's launch in 2010. The shekel has remained firm against the USD during this period, but Israeli stocks have given back much of their relative gains from 2005-2010.

Israeli Relative Performance Disconnected From Shekel After QE2



The process has been erratic for the comparison against the Eurozone as well. Here the incremental total return in EUR terms was lower during the run-up to the financial crisis, but the downturn has been just as defined. The cross-rate between the EUR and ILS has traded in a fairly narrow range since the financial crisis, which is a pretty good trick considering the Eurozone's propensity for random crisis generation.



What are we left with, then? It appears as if the foibles of both the dollar and the euro have prompted Israeli firms to manage their currency risk fairly completely since the financial crisis and various rounds of QE. However, it seems the high-tech and intellectual property firms that populate the Israeli market make it a collection of "story stocks" as opposed to a market rising and falling with broader macro themes. The net result has been a multiple-year performance advantage by Israel over both the U.S. and the Eurozone came to an end when those developed markets became macro, chiefly monetary policy, markets. Israeli stocks and their link to the shekel thus present a very different picture than do other emerging markets.