Israeli Shekel Very Sensitive To Relative Interest Rate Expectations

In honor of the awkward lovefest associated with Benjamin Netanyahu's speech to Congress this week, should we remind him of the old joke Israel was settled by people who wandered for forty years in the desert only to come to the only spot in the Middle East without oil?

But in a tough neighborhood where a lot of things are booming, so, too, are Israel's vibrant technology and agricultural export sectors. This makes the exchange value of the Israeli shekel (ILS), a currency of Biblical proportions, against both the euro and the dollar very important. As fate would have it with the European Central Bank's relentless drive to improve the lot of the average European by making the currency as worthless as possible as soon as possible, the ILS has been weakening against the dollar while it has been strengthening against the euro.

Fun fact: The word "shekel" derives from a Hebrew word meaning, "he weighed." Monetary terms around the world often originate from neighboring empires; the shekel appears to be of Babylonian origin. How captivating.

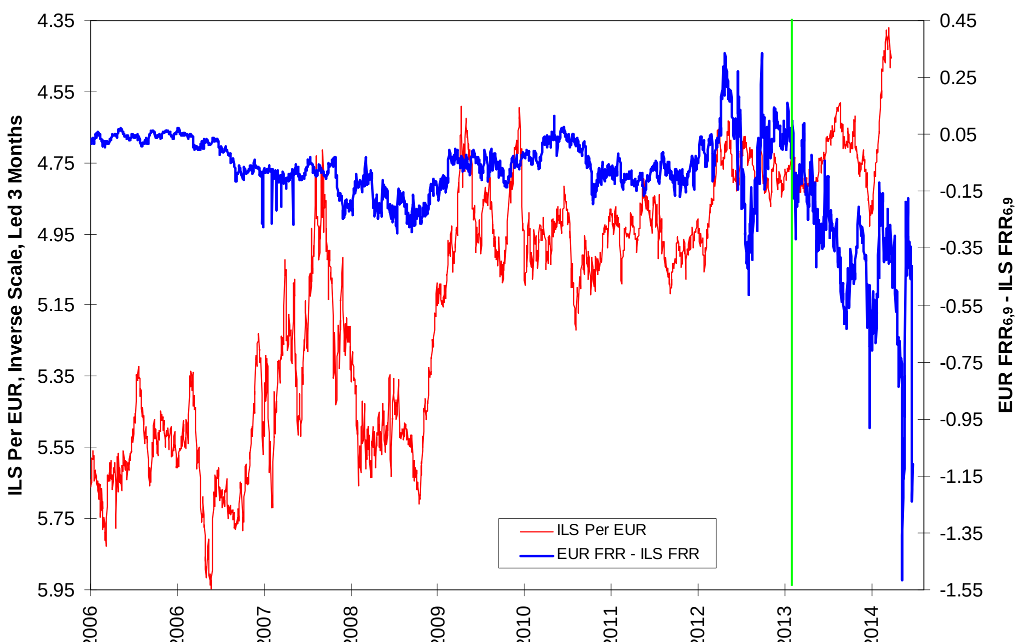
Equity Performance

The key to the divergent exchange rate paths is the divergent set of short-term interest rate expectations as measured by the forward rate ratios (FRR) between six and nine months. These are the rates at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. A FRR greater than 1.00 indicates a positively sloped yield curve; one below 1.00 indicates an inverted yield curve. The one for the euro is negative right now as nine-month swap rates have collapsed.

Israeli equities have gained 42.3% in ILS terms since the Eurozone FRR began to flatten relative to the ILS FRR on October 8, 2013, marked with a green vertical line. In contrast, the MSCI Eurozone and U.S. indices have advanced 30.7% and 30.6% in local currency terms over this same period. The returns for the Israel and Eurozone indices in USD terms were 27.1% and 7.8%, respectively.

This EUR-ILS FRR differential leads the EUR/ILS cross-rate by three months on average; the ILS has gained 5.58% against the EUR adjusted for the three-month lead-time over this period. The collapse of the EUR FRR to negative levels has led to a decrease in the expected interest rate differential. This suggests the ILS' strong gain on the cross-rate will start to retreat in the April/May timeframe.

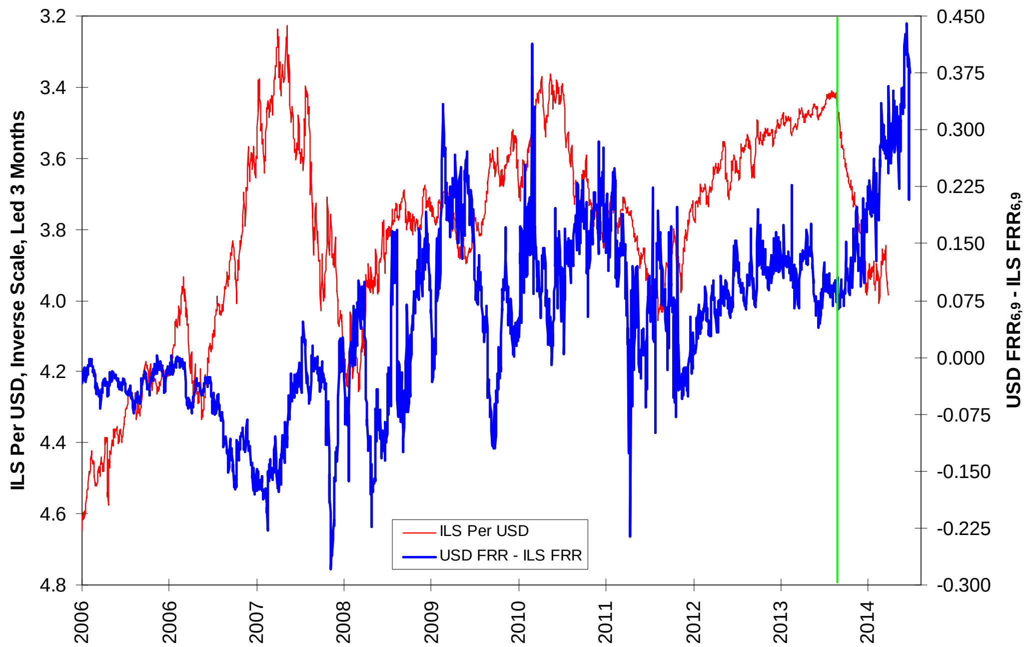
ILS Rose Against EUR After EUR $FRR_{6,9}$ Inverted Relatively



The pattern has been different for the USD/ILS rate and the USD-ILS FRR. The USD FRR began a relative steepening on May 28, 2014, marked with a green vertical line; the ILS has weakened 12.42% adjusted for the three-month average lead-time.

While the dominant pattern has been for the ILS to strengthen as the expected interest differential expands, this did not happen over the June-August 2014 pattern. The ILS has twice found support near 4.00 over the past three months, but this level looks like it will be tested again soon as the FRR differential is starting to narrow rapidly as the USD FRR is starting to flatten.

ILS Fell Against USD After USD FRR$_{6,9}$ Steepened Relatively



All of this interest rate expectation volatility and unstable exchange rate movement is bad for all involved, both in the Israeli case and elsewhere. The euro was formed in part for its member states to focus on things other than currency management; see how well this has worked?