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	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
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Not-Rated/Hold	2	0%	0	0%	0%	0	0%
Underweight/Sell	610	17%	68	11%	11%	224	14%
Total	3,623		641			1547	

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Israel Economics and Sovereign Credit Strategy | EEMEA

Uncertain Months Ahead

The Knesset took a first step towards reducing judiciary influence over lawmaking and public policy. We see increased uncertainty about the economic outlook in the coming months and risks becoming skewed to our adverse scenario. Markets are now likely to extrapolate the future policy path and we move Israel sovereign credit to a dislike stance.

Economics | A more uncertain economic outlook: The Knesset passed the bill abolishing the 'reasonableness clause' in a 64-0 vote yesterday, with the opposition deciding to boycott the vote. The bill represents the first step of the current coalition government's plan to change the balance of power between the judicial and legislative branches, reducing judiciary influence over lawmaking and public policy. While the Knesset will be on a summer recess from August until early October, PM Netanyahu said that the governing coalition will be in contact with the opposition to explore the opportunity of reaching consensus on the reform path ahead until November. Meanwhile, members of the opposition have signalled that they will challenge the bill in the Supreme Court, which could eventually strike it down.

The recent events point to continued uncertainty and thus the potential for an increased risk premium that would lead to weakening FX and higher borrowing costs. In our recent [initiation note](#), we highlighted that such economic shocks tend to lead to weaker GDP growth due to lower business investment and private consumption growth. The weaker currency tends to impact core inflation only marginally if the economic shock is temporary, but could have a more meaningful impact if the depreciation pressures prove sustained. As such, in our adverse scenario we think that growth could weaken significantly to 1.6%Y in 2024 with inflation remaining significantly above the BOI's tolerance band despite the central bank raising its policy rate to 6.25% this year. For now, we keep [our call](#) for one more 25bp hike to 5.00% at the BOI's September meeting, but risks to the rates outlook are now shifting to the upside again. For more details, see [Israel Economics and Strategy: A Test of Resilience](#), June 7, 2023.

Sovereign credit strategy | Markets likely to extrapolate: The passage of the 'reasonableness clause' reform bill could embolden further reform action once the Knesset reconvenes in October, [as was suggested](#) by Justice Minister Levin following the vote. This means that while the pace of newsflow out of Israel should subside after this week, the market is likely to extrapolate the reform process between now and October as we receive more detail on the next policy proposals. In the interim, we think that investors will now find it more difficult to develop a constructive view, leaving risk assets without a clear anchor. Rating agencies have also flagged reform-driven institutional deterioration as a downside factor if this leads to weakened macro-fundamentals. Reviews are upcoming in October/November.

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Exhibit 1 : We believe that Israel's outlook is dependent on the resolution of domestic tensions

	Upside Scenario		Base Case		Adverse Scenario	
	2023F	2024F	2023F	2024F	2023F	2024F
Real GDP (%YoY)	3.2	3.6	2.5	3.0	1.0	1.6
CPI (avg. %Y)	4.0	1.8	4.5	2.9	5.1	4.3
CPI (eop. %Y)	2.6	2.0	3.8	2.6	5.2	3.8
Key rate (eop. %)	4.00	3.00	5.00	4.00	6.25	5.50
Current account (% GDP)	3.7	3.8	3.6	3.7	3.2	3.4
Budget Balance (% of GDP)	-1.3	-2.1	-2.2	-3.0	-4.2	-4.8
Govt. Debt (% of GDP)	57.2	55.1	58.7	56.4	61.7	59.3

Source: Haver Analytics, Morgan Stanley Research forecasts

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We close our recommendation to buy ISRAEL 07/30 versus ISRAEL 07/50 and position more defensively, moving Israel sovereign credit to a dislike stance. 10s30s have risen to 80bp and absolute spreads are still at the relative tightness of the post-March period. While we are closer to a downside scenario, two factors are now upside risks. First, an indication of potential success of a legal challenge would likely reverse some of the weakness. Second, the market would also likely react positively to signs of a reconsideration of the future policy trajectory on account of the public response, security considerations or external political pressure.

Exhibit 2: Valuation methodology and risks

Stance/Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Dislike Israel Hard Currency Bonds	25-Jul-23	NA	NA	NA	With the reform of the reasonableness clause having passed, the market is likely to extrapolate the future policy trajectory. This means that it is unlikely that credit will try to fade the weakness as investors will find it more difficult to construct an upside case, leaving little marginal buying. Institutional deterioration and rating agency responses are also a possibility.	A successful legal challenge or signs that future reforms will be softened in response to domestic or external pressures.

Source: Morgan Stanley Research

Exhibit 3: History of recommendations for Israel hard currency bonds

Trade	Entry Date	Exit Date
Dislike Israel Hard Currency Bonds	11-Jul-22	18-Nov-22
Like Israel Hard Currency Bonds	18-Nov-22	12-Dec-22
Like Israel Hard Currency Bonds	18-Jan-23	21-Feb-23

Source: Morgan Stanley Research

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