# BlueStar Israel Equity Review and Outlook

**1016**
**Monthly Update**

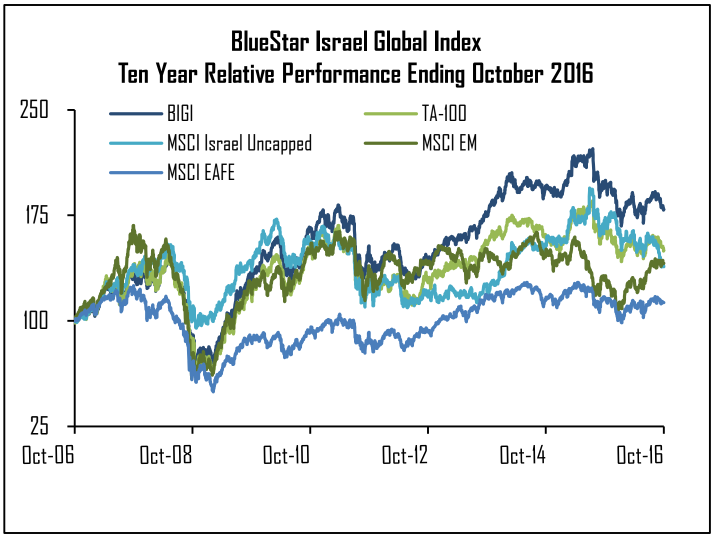
The BlueStar Indexes® Monthly Update covers Israeli equities traded worldwide. The BlueStar Israel Global Index® (BIGI® or BLS:IND on Bloomberg) is used as the benchmark for our review as it represents the complete opportunity set of Israeli equities. BIGI® is tracked by the NYSE-listed ISRA Israel ETF, by two TASE-listed ETNs, and by an Israeli-registered mutual fund. Israel has one of the world's most resilient economies, its technology sector is a global innovation leader, and its companies have a global footprint. The Update provides insight into macro forces, the geopolitical environment in which Israel's economy operates, and the individual companies that have contributed to Israeli Global Equities' impressive long-term performance.

## Navigating an Uncertain Market with Israel Index Strategies

November 4, 2016

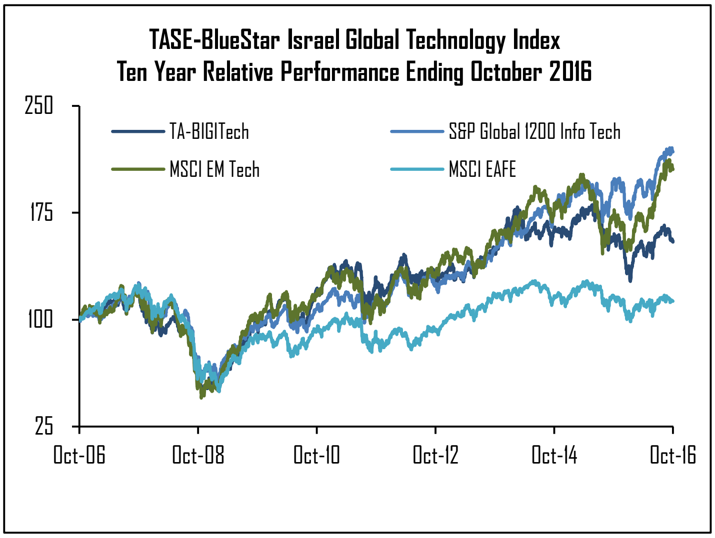
### Performance Review

Israeli Global Equities, as measured by BIGI®, declined more than 4% in October, continuing the pullback that began in September. Israeli Global Technology Equities, as measured by the TA-BIGITech® benchmark, underperformed the broader Israeli equity market for the first time in five months, giving up nearly 5% in October. BlueStar's Israel equity indexes performed in-line with other Israeli equity benchmarks like the MSCI Israel and TA-100 indexes. Many of the themes and trends we have pointed out throughout Q2 and Q3 2016 continued into Q4 including the following: investors preferring domestically-oriented sectors of the market over global-oriented sectors, Health Care continuing to underperform heading into the US elections, and investors positioning for higher growth, higher inflation and higher interest rates. Click here for BlueStar's monthly Technical Analysis update.




**Global Equity Benchmark Comparison: October 2016**

| Benchmark | Period Return (%) |
|---|---|
| BIGI® | -4.29 |
| MSCI Israel | -3.83 |
| TA-100 | -4.61 |
| S&P 500 | -1.82 |
| MSCI EAFE | -2.05 |
| MSCI EM | 0.24 |




**Global Technology Stock Index Comparison: October 2016**

| Benchmark | Period Return (%) |
|---|---|
| BIGITech® | -4.77 |
| Nasdaq-100 | -1.49 |
| S&P Global Tech | -0.51 |
| TA- Tech Elite | 0.09 |
| EM Internet & E-commerce | -1.27 |

## Market Trends and Outlook

The cross currents of political/regulatory risk, monetary policy developments, economic growth, sector rotation and technical analysis are extremely fluid, dynamic and complex but, as always, there is a place or strategy for Israeli equities to take advantage of these developments. Overall what BlueStar sees developing in global markets is a set up for the next leg of the current bull market cycle which began in 2009. We come to this baseline outlook predominantly as a result of developments in global monetary policy.

We think that the tentative coming monetary tightening cycle is both in reaction to positive economic developments and a leading indicator of positive economic developments. The current state of monetary policy is that interest rates in virtually all Developed Markets have been, are, and will likely continue to remain below the "equilibrium" rate for several more years to come even if one takes the view that the equilibrium rate is lower now than before the Great Recession. Over the last two quarters we have seen labor markets firm, and we have seen signs of wage and price inflation. Our main thesis is that a gradually rising rate cycle will accelerate these trends, not quash them as many fear: rising interest rates or the perception of rising rates will induce current over future consumption through two mechanisms.

The first mechanism is best illustrated by way of example. Suppose you are currently renting an apartment or house but have been wanting to buy. Even though interest rates have remained historically low levels for the past six or so years, because you expected rates to remain low you were comfortable waiting to purchase your home or apartment. But now circumstances have changed: it seems likely that the cost of financing your new home will rise in the immediate future and therefore it makes more economic sense to buy now rather than wait. This is a classic example of how interest rates and expectations influence consumer behavior, but it extends to companies and investment in fixed assets. In aggregate this behavior is likely to increase current demand and in turn accelerate the pace of inflation, greater corporate top line growth, higher fixed capital investment and higher global economic output. The second mechanism is related to savings rates. With negative and ultra low interest rates savers need to put away a greater percentage of their income in order to achieve their financial goals. However if interest rates rise then investors will not necessarily need to put away as much of their income and will have more funds available for current consumption. This path would lead to the same results as the first and they would both be supportive of equity markets.

A July 2016 report by Bernstein titled "Brexit: Roadblock or Speed Bump En Route to a 20,000 Dow?" included a very interesting scatterplot of the US 10-year treasury yield and price-earnings ratios based on trailing twelve month earnings of the S&P 500 index. The main takeaway is that price-earnings ratios have a distinct tendency to be above average when the 10-year treasury yield is between 3.5% and 6%. As of November 3, 2016 the 10-year treasury was yielding 1.8% and has not gone above 3.5% since before 2008. This is yet another indication that, because interest rates are still accommodative, inflation and rising interest rates can accelerate actual and expected corporate revenue and earnings growth leading to higher price-earnings ratios and a strong stock market.

Further support for our outlook comes from internal market behavior over the last year or so: last month we elaborated on our assertion that investors have begun to express a preference for growth-oriented stocks/sectors over "value"/dividend-oriented stocks/sectors with the following statistics. From 2014 through June 2016 the S&P 500 Equal Weight Utilities and S&P High Dividend indexes were up 42% and 31%, respectively, while the S&P 500 and Russell 1000 Growth indexes were up just 19% and 16% respectively. In the same time period both Developed Market ex-US and Emerging Market stock indexes were down significantly. But the middle of 2016 marked a turning point: the S&P 500 Equal Weight Utilities and High Dividend Indexes are down roughly 11% and 1%, respectively, since June 30 2016 while the S&P 500 and Russell 1000 Growth indexes are up roughly 3% and 4%. The MSCI EAFE and EM indexes are up 6% and 10% in the same period.

This change in market leadership coupled with the overhang of the geopolitical, political and regulatory uncertainty due to convoluted messaging from global central banks, saber rattling by Russia and NATO, and the US Presidential elections is confusing for markets. Also the economic logic we laid out above takes a bit of time to show up in the data. These and technical patterns are the reasons for recent market weakness and we would not be surprised if it continues into the end of 2016 and beginning of 2017.

### Top Israeli Equity Gainers and Losers: October 2016

| Top-performing Israeli Stocks (%) | | Worst-performing Israeli Stocks (%) | |
|---|---|---|---|
| Kamada | 13.02 | Imperva | -31.30 |
| Xlmedia | 10.08 | Chiasma | -23.47 |
| Kornit Digital | 9.81 | Alcobra | -22.27 |
| Check Point Software | 8.96 | Supercom | -21.87 |
| Ceragon Networks | 8.90 | Stratasys | -20.63 |
| Menora Mivtachim Holdings | 8.28 | Solaredge Technologies | -20.49 |
| Harel Insurance | 7.20 | Ceva | -14.31 |
| Clal Insurance | 6.93 | Foamix Pharmaceuticals | -14.15 |
| Sapiens International | 6.58 | Medgenics | -13.46 |
| El Al Israel Airlines | 6.35 | Perion Network | -13.33 |

**Source: BlueStar Global Investors LLC; Currency-Adjusted returns in dollar terms**

### Israeli Equity Sector Performance: October 2016

| GICS | Sector Return (%) |
|---|---|
| Financials | 1.02 |
| Industrials | 0.34 |
| Utilities | -0.37 |
| Consumer Staples | -0.72 |
| Telecommunication Services | -2.29 |
| Energy | -2.59 |
| Consumer Discretionary | -2.86 |
| Information Technology | -3.01 |
| Real Estate | -4.01 |
| Materials | -4.55 |
| Health Care | -10.39 |

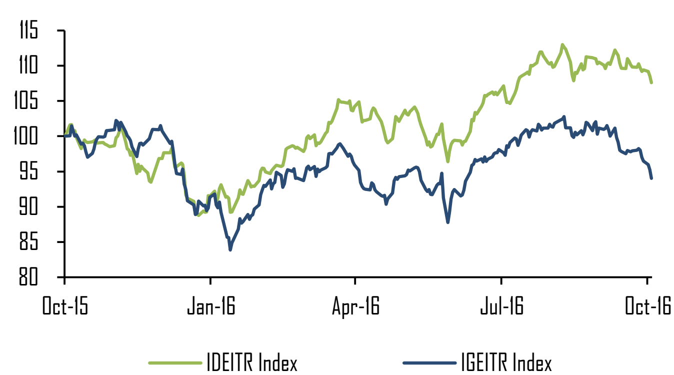
## Israel Economic Update and Economic Exposure Index Trends

The Solactive - BlueStar Israel Domestic Exposure Index (IDEI), which is comprised of Israeli companies that get most of their revenue from within Israel, experiences periods of extreme out- and under- performance both relative to BIGI®-TIM (BlueStar Israel Global Total Investable Market Index) and compared to the relative performance of the Solactive – BlueStar Israel Global Exposure Index (IGEI), which is comprised of Israeli companies that get most of their revenue from outside of Israel. One of the reasons this is possible is that because of the large weight of globally-oriented companies such as Pharmaceuticals, Information Technology, and Materials companies in BIGI®-TIM the correlation between the IDEI and BIGI®-TIM is much lower than the correlation between the IGEI and BIGI®-TIM.

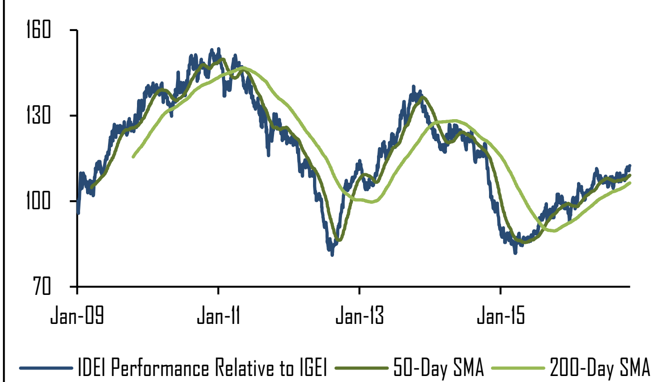
We have been watching the relative performance of our economic exposure indexes for many months now and it seems that we are now likely entering the final period of outperformance of the IDEI over the IGEI. Our conclusions from analysis of technical patterns also comport with our fundamental economic view outlined on the previous page and our study on the Health Care sector on the following page.

While the economic news out of Israel was light in October, the economy has been experiencing robust economic growth driven mostly by sources of domestic consumption: real estate, consumer staples and financials. Although there are no signs of a retreat in domestic consumption it is likely that the relative prices of Israeli equities most closely tied to those sources of consumption are nearing their upper limits vis-à-vis the prices of Israeli equities tied more closely with global trade. As noted on the previous page we believe that global investors are beginning to favor areas of the equity markets with greater growth prospects which would include those sectors represented in the IGEI: Technology, Health Care and Materials. Also, as discussed on the following page, Health care stocks – Pharmaceuticals and Bio-tech in particular – are in technically oversold territory despite regulatory uncertainty in the US. In general the greatest potential for acceleration in Israel's economic growth comes from its export sector which stands to benefit from growth in global trade. As investors position their portfolios for growth, Israel could be an important piece in an investor's toolbox.

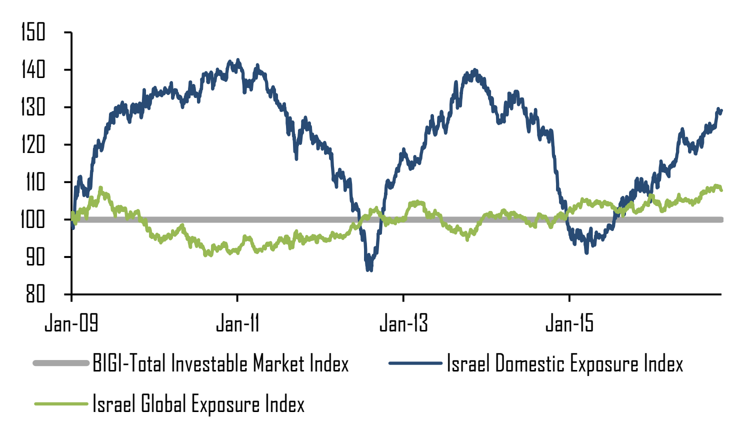
Comparative Performance: Twelve Months Ending October 2016




IDEI Performance Relative to IGEI From 2009 Through October 2016



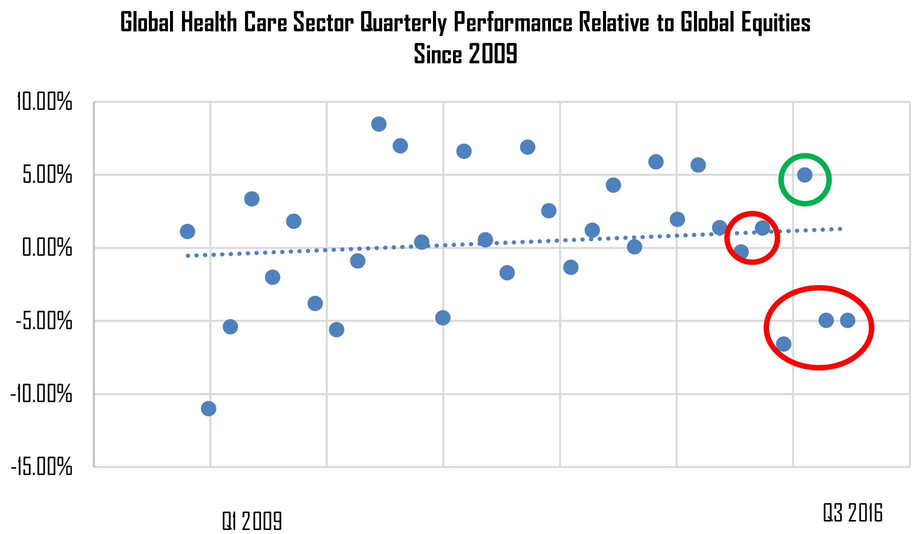

Israel Economic Exposure Indexes Performance Relative to BIGI-TIM From 2009 Through October 2016

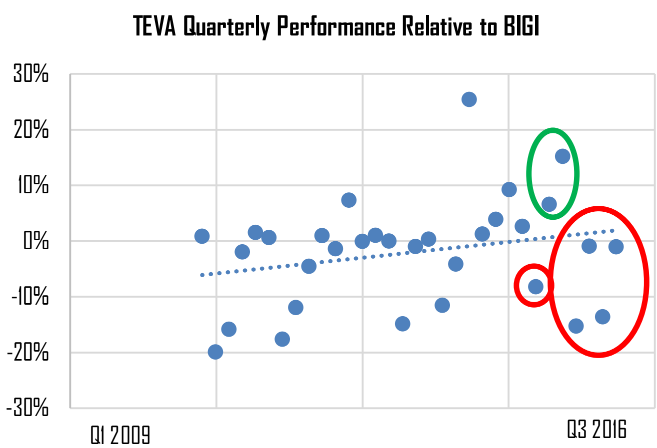


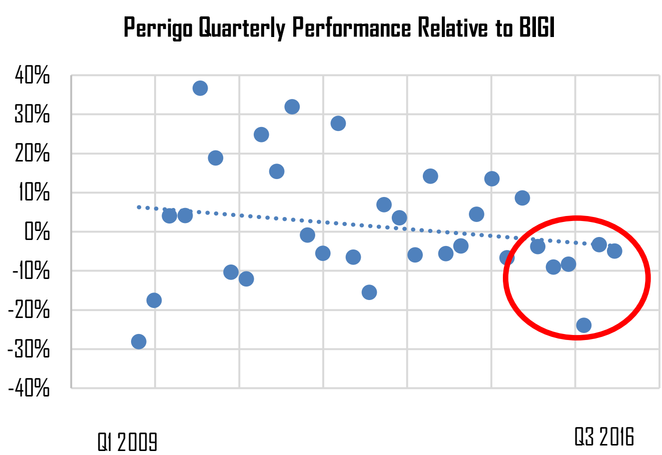
## Sector/Company Spotlight

Over the past year the level of underperformance by Teva and Perrigo as it relates to the broader Israeli equity market has been notable. Stabilization or perhaps recovery in this industry along with visibility into the regulatory environment after the US Presidential elections could provide a major tailwind for the broader Israeli equity markets and the IGEI in particular. We have updated the scatterplot charts below to include a point for Q4 2016 to-date in which the Israeli Health Care Sector dropped more than 10%! The Q4 2016 underperformance of the Israeli Health care Sector was exacerbated in early November with news that the US Justice Department issued subpoenas to several of the largest generic pharmaceuticals companies including Teva. Also among the greatest laggards in that sector in October were several of Israel's leading bio-tech companies.

The charts below show the performance of the Global Health Care Sector, TEVA, and PRGO relative to their respective benchmarks on a quarterly basis for the last 8 years and October 2016. Without testing for significance we observe that the Global Health Care Sector, TEVA and PRGO have experienced below expected relative performance for more than two-thirds of the three month periods over the last year and a half, and October 2016 added to that trend. These charts show there is an increasing chance that the Global Health Care Sector and among it the two largest Israeli Pharmaceutical companies, will have greater than average relative performance in several of the coming three month periods. If this materializes it would bode well for the overall performance of the Israeli equity market especially given recent strong economic growth data.

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