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ANALYSIS-Israeli share rally may have hit its limit.
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TEL AVIV, May 19 (Reuters) - Tel Aviv shares have surged some 40 percent in the past three months, but analysts say the rally could be over, as economic and political reality brings them back to earth.

Israeli shares have risen despite industrial unrest, the worst recession in 50 years and continuing security uncertainty.

But falls of more than four percent in the past two days following a string of suicide bombings that have killed nine Israelis since Friday show that recovery depends on a solution to the political situation, economists said.

Analysts attribute the Tel Aviv Stock Exchange's (TASE) climb to the rapid end of the U.S.-led war in Iraq, which decreases the overall security risk to Israel, along with the possible renewal of Palestinian-Israeli peace talks.

Defence spending, which has shot up since the outbreak of the Palestinian uprising in 2000 and put enormous strains on the budget, may now be cut due to the reduced risk. Meanwhile, foreign investors who pulled out of Israel due to the uprising could return.

But Shlomo Maoz, macro-economic analyst at Nessuah Zannex Securities, believes the market's rise has been artificial and was mainly due to a rosy foreign view of the security situation.

"(Palestinian Prime Minister) Abu Mazen cannot control the Palestinian Authority and (Israeli Prime Minister Ariel) Sharon will not give up on settlements," Maoz said. "The political situation remains difficult and will take a long time to resolve."

NO MORE UPSIDE

Analysts believe there is little upside left for the market, since Israel's fundamental political and economic problems remain unaltered.

"Given the ongoing political and economic uncertainties, the sharp rises took us by surprise," trader Shai Yitzhaki of Meitav Investment and Consulting said.

"After all, the structural problems of the economy and the problems with the Palestinians are deep and are still with us."

After surging to around 420 points earlier this month from 300 points in early February, the Tel Aviv-25 index of blue chips and TA-100 index were both down on Monday following falls of more than three percent on Sunday due to a wave of suicide attacks.

The TA-25 closed down one percent on Monday at 391.12 points while the TA-100 slipped 0.5 percent to 401.15 points.

ECONOMIC PLAN MAY BOOST SHARES

Economists said a plan to cut spending by 11 billion shekels ($2.4 billion) to rein in a swelling budget