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Japan Crisis: A Human Disaster But Not An Economic Disaster

Executive Summary

- **A 9.0 magnitude earthquake struck off Japan's coast on Mar. 11 has left at least 21,000 people dead or missing; Global investors eyeing the developing nuclear situation at Fukushima.**
- **In the short run, economic activities are expected to slow in Japan. The triple catastrophe is likely to affect other economies but unlikely to cause these economies to sink into recession.**
- **We feel that the Japanese equities are trading at an attractive valuation. Wall Street Journal reported that the Nikkei 225 Index is trading at the cheapest in over 40 years.**
- **Western insurers' losses hinting that the financial consequences may be felt outside of Japan.**

Introduction – Triple Disasters in Japan

A 9.0 magnitude earthquake struck off Japan's coast on Mar. 11 has left at least 21,000 people dead or missing. Since the earthquake struck, media reports have been detailing the repercussions of the disaster on the country's economy. Global markets experienced a tremendous level of volatility over the past one week as investors continue to monitor the developing nuclear situation at Fukushima.

From an investment perspective, this may present an opportunity for investors to gain exposure in Japan. According to a latest report from Barron's, investors have pumped record amounts of money into Japanese ETFs and equity mutual funds since the start of the earthquake. Contrarian investors are convinced that every dip is a buying opportunity. Billionaire investor Warren Buffett believes that Japan's devastating earthquake is the kind of extraordinary event that creates a buying opportunity for shares in Japanese companies. Given that fears over a nuclear disaster in Japan are quelled with the growing optimism that the worst is over, we feel that the situation in Japan may turn out to be less than catastrophic.

Latest Developments – Nuclear Fears Persist

In the aftermath of the nuclear meltdown, radioactivity fears grew. Japan reported above safety radiation levels in 11 types of vegetables, in addition to milk and water. High quantities of radioactive cesium and iodine were also detected in seawater.

According to the U.S. Geological Survey website, a 6.6 magnitude earthquake struck off the east coast of Honshu in Japan on Mar. 22. The earthquake struck at 3.18pm Singapore time. There was no word of any damage, casualties or a resulting tsunami at the time of writing.

Kyodo news agency reported that black smoke was seen rising on Mar. 23 from the number 3 reactor of Japan's crippled Fukushima nuclear plant. There have been several blasts of steam from the reactors during the crisis, which probably released a small amount of radioactive particles. So far, experts said readings are much lower than around Chernobyl after the 1986 accident in Ukraine.

Economic Impact:

In the short run, economic activities are expected to slow in Japan as infrastructures are ruined, and energy supply crippled with the closure of nuclear power plants. Trade is also expected to ease as production comes to a standstill and as trading partners blocks food imports from Japan. As of this writing, United States became the first country to block food imports from Japan. Tourism sector will also be affected as foreigners shun the country on concerns of high levels of radiation. With that, we can also reasonably expect retail sales to inch lower in the interim. Plummet confidence among Japanese could also exert a toll on retail sales.

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In the mid term, if history was of any guide, it tells us that it reconstruction need not necessarily lead to growth in the economy. As shown in the figure below, between 2007 and 2008, real GDP declined in the next quarter after an earthquake hits.

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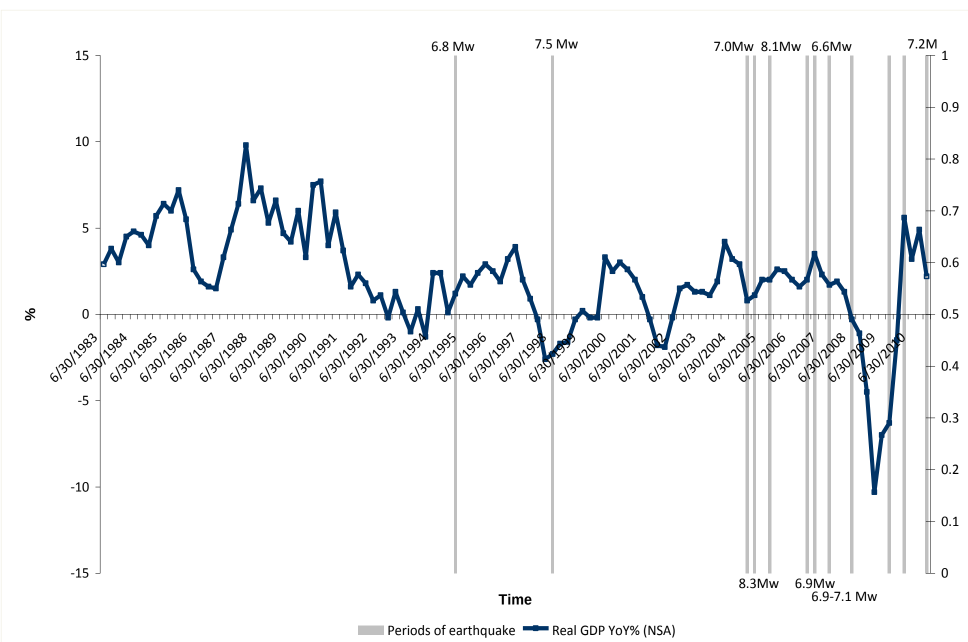
Chart 1: Japan Real GDP YoY% (NSA)



Source: Bloomberg, as of Dec 2010

China paints a similar picture. As shown in chart 2, the country's GDP did not increase after a natural disaster occur.

While the above might be the case, the severity of the recent event is greater than any of the previous earthquakes that occurred and we believe that the reconstruction to take place will be positive for the country. Sectors that are likely to benefit include industrials, basic materials and consumer, non-cyclical industries. According to a report on Nikkei newspaper reported on 23rd March, the Japanese government expects total damage to reach 15 trillion to 25 trillion. The estimate

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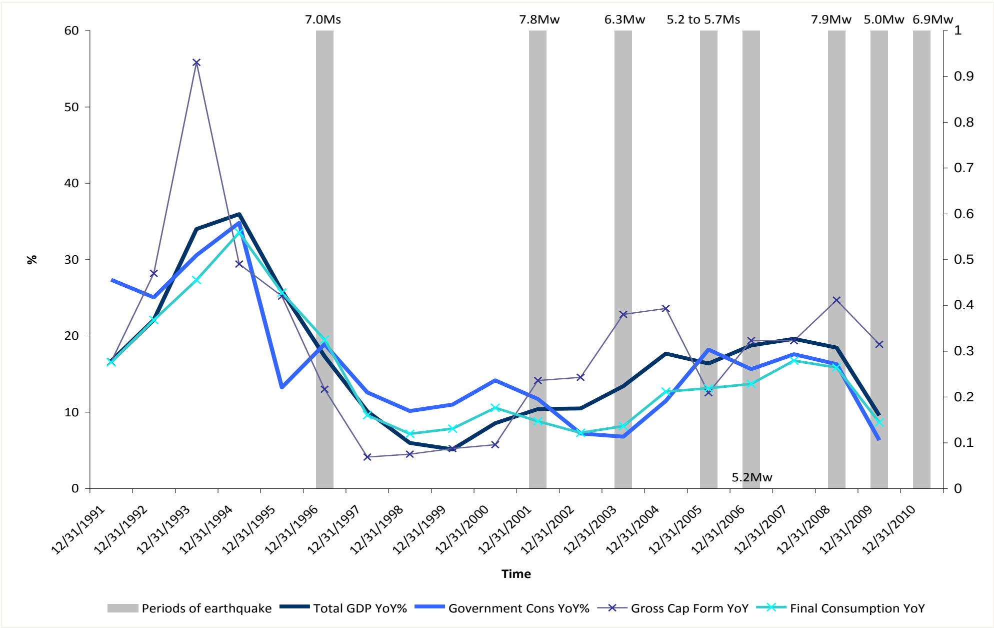
Chart 2: China GDP YoY%



Source: Bloomberg, as of Dec 2010

covers damage to roads, homes, factories and other infrastructure but does not include losses to economy activity. According to the report, that amount is larger than the 10 trillion yen in damage from the Kobe earthquake in 1995.

Meanwhile, we think the triple catastrophe is likely to affect other global economies in two ways. Firstly, we are concern that reconstruction in Japan might exert further pressure on commodity prices; which are currently at elevated levels. This in turn might aggravate inflationary pressures especially in emerging countries. Secondly, Japan is afterall the third largest economy and any slowdown in economic activity is likely to be felt in other regions of the world. This impact is likely to be felt through lower Japanese exports. Other than Japanese food products, Japan also supplies technological products, semi-conductors and other materials to the global manufacturing industry. Disruptions in the supply of these components are likely affect the production of these economies. While the above are the likely impacts, we do not think that it will cause global economies to sink back into recession. This is so as the fundamentals of these other economies are strong and positive at the moment.

We think the triple catastrophe is likely to affect other global economies in two ways. However, it is unlikely to cause these economies to sink back into recession.

Financing the cost of reconstruction

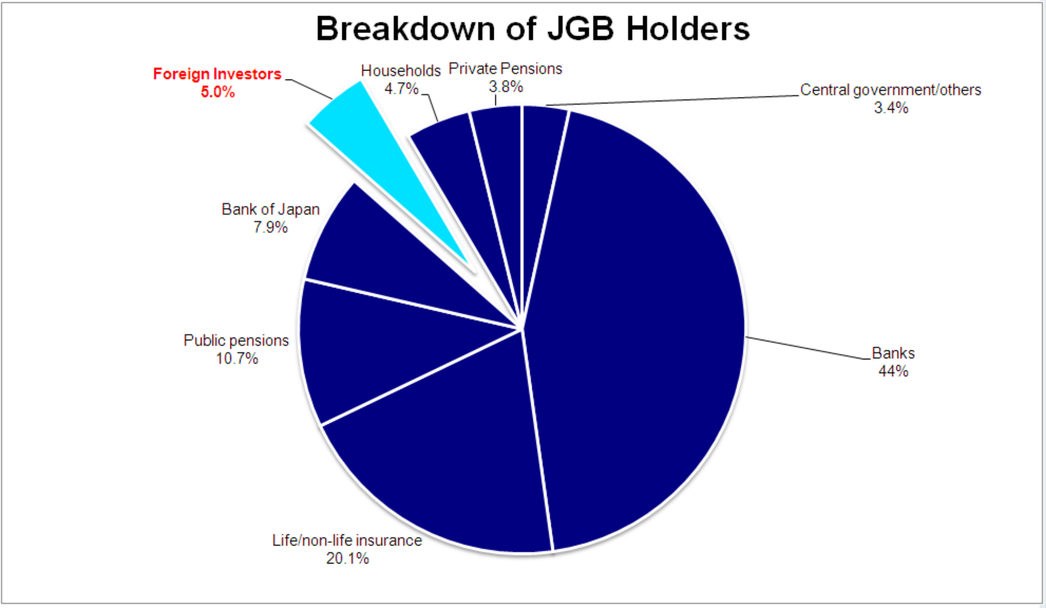
We feel that the overall financial position of Japan is strong enough to support the massive government spending required for the country's rebuilding moving forward. On the numbers, Japan's public debt levels stood at an alarming level, 200% of GDP. Therefore, many economist pointed out previously that Japan's public debt level may prove to be a major impediment in the country's recovery. We beg to differ.

Firstly, majority of Japan's sovereign debts are held locally. 95% of Japanese public debts are held by the locals (See Chart 3 below). The debt of one government agency is held by another governmental agency as an asset. As such, Japan's net foreign liabilities is much lower than many believe. This is supported by the low debt interest burden as well. The debt interest as a percent of GDP in Japan is half of the European counterparts, with the yield on 10 year Japanese government bonds standing at 1.2% post earthquake.

In terms of funds available for rainy days, Japan's central bank (BOJ) holds over US$1 trillion of foreign reserves (roughly 20% of its GDP), second only to China. At the same time, the Japanese yen is a fiat currency issued by the BOJ, which has full control over the issuance of the currency. The central bank has absolute control over its monetary policy. To calm the market, it has pumped a record amount of funds into the financial system since Mar. 11 to great efficiency. Lenders' deposits with the central bank stood at an all-time high of US$539 billion as of Mar. 22, from US$218 billion the day before the temblor struck, according to Bloomberg. Any sovereign debt default risk as a result of the earthquake disaster is certainly overstated. A similar European PIIGS debt implosion is also unlikely.

Lastly, Japan derives most of its wealth from its private sector. The total wealth of Japan's private sector is estimated to be more than four times its net public sector debt. The net worth of its private sector is estimated to be at US$23 trillion as of end 2009. The financial position of Japan is in a less than undesirable state.

Chart 3: Foreign Holdings of Japanese Government Bond is Low



Source: Bank of Japan, as of Sept 2010

Majority of Japan's government debts are held locally. Only 5% are held by foreign investors .

Japanese Equities – Volatility and Opportunity

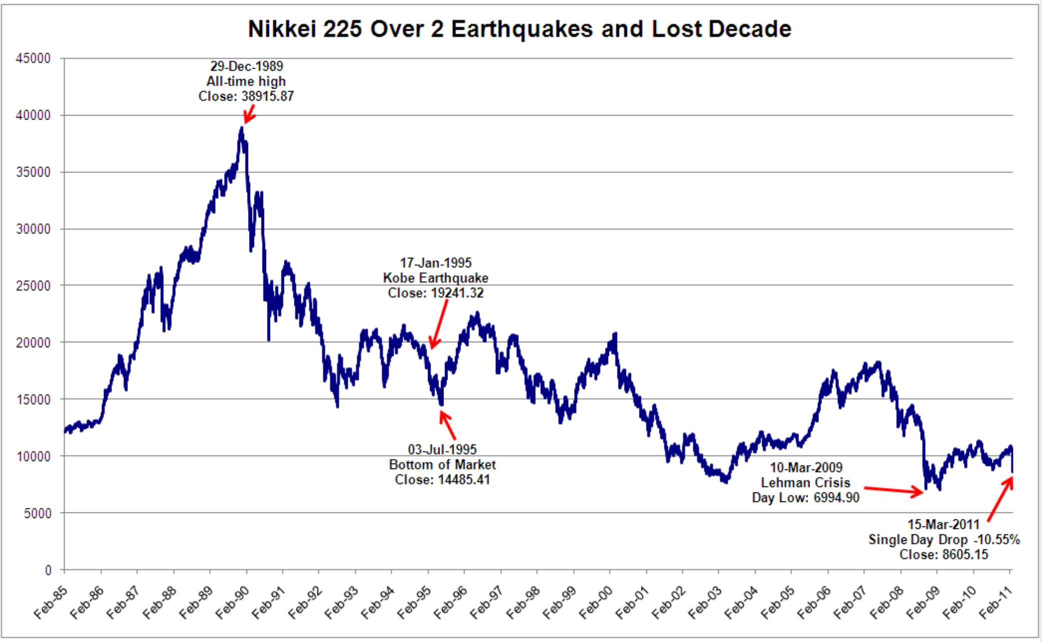
Japanese equities took a big hit, as the Nikkei 225 Index tumbled 20% from its Mar. 9 high to an intra-day low on Mar. 16. It was the worst decline over such a short time frame since the 1987 crash. Implied volatility on the Nikkei soared from 21 to 70 — within striking distance of the 92 peak reached after Lehman collapsed.

We feel that the Japanese equities are trading at an attractive valuation. The current stock prices value Japan's companies at 1.23 times book value. In contrast, the MSCI World Index is priced at more than twice book value, double what it is in Japan. Accordingly, Wall Street Journal reported that on a 10-year cyclically smoothed basis, the Nikkei 225 Index is trading at a Price-to-Earnings multiple of 14.5 times, which is about the cheapest the market has been in over 40 years. The report also pointed out that the Japanese and United Kingdom equity market capitalization levels are roughly the same but global mutual funds and ETFs have 25% less of their assets in Japan.

To a large degree, we feel that this crisis has been priced into the stock prices in Japan. The panic sell-off on Mar. 16 was an example of such extreme behavior whereby market reacted irrationally in the form of indiscriminate selling. In fact, the media itself has successfully portrayed the worst outcome of a nuclear mishap to the masses. Despite this, we feel that the situation in Japan may turn out to be less than catastrophic.

With reference to previous market downturn, long term bull markets begin when valuations are at multi-year lows. Marginal buyers will enter the equities market as marginal sellers begin to diminish. Therefore, we expect the crisis to be a good opportunity to buy into Japanese equities for the medium to long term. Short term volatility is likely to be here to stay with ongoing media exaggeration on the extent of the nuclear disaster. However, with the BOJ pledging almost unconditional support to Japan's financial markets' stability, investors should look to buy the dip.

Chart 4: Nikkei 225 Over 2 Earthquakes and Lost Decade



Source: Bloomberg, as of 23 Mar 2011

The Nikkei 225 Index remains 75% down from its all-time high in 1989, as of close on Mar. 23.

Global Insurers on Alert

American and European reinsurance firms are likely to suffer massive losses in insured property damages. According to initial estimates, insurers are likely to be hit with losses in the region of US$35 billion, the second largest insured loss from a natural disaster in history. Reinsurance giant Swiss Re projected that claims may total US$1.2 billion on damages associated with the earthquake, according to Bloomberg.

On a positive note, the impact from accidents in Japanese nuclear power plants are unlikely to have a significant affect on private insurance industry and most of it will likely be covered by the Japanese government. At the same time, Japanese government provides earthquake insurance for individuals homes, and does not re-insure that risk abroad.

However, the insurers' losses are hinting that the financial consequences may be felt outside of Japan. Although the losses will not be enough to overwhelm the insurance companies, the insurers will be obligated to liquidate or redeem billions of dollars worth of foreign stocks and bonds to meet the expected claims payments. Repatriation will result in continual rise in the yen currency, despite G7 intervention on the appreciating yen. This present an imminent downside risk on global bonds and stocks outside of Japan.

Looking Ahead

History taught us that natural disasters tend to cause great short-term pessimism but have minimal lasting effect on financial markets. In fact, the rebuilding in Japan following a disaster would be an economically positive event. Over the next few years, we expect Japan's GDP to rise, with the help of the reconstruction boom. As the great economist, Milton Friedman illustrated, having people to dig holes and then fill them up again in the form of reconstruction is a good impact on the country's economy. This earthquake will shake Japan out of its past two decades of deflationary cycle.

"You never want a serious crisis to go to waste," former White House Chief of Staff Rahm Emanuel was quoted saying. We believe investors may look back and isolate the current Japan disaster as a single black swan event. Buy the dips.

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