

Japan's Ghastly Trifecta: Earthquake, Tsunami and Nuclear Breach

Initial Thoughts and Observations

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Portfolio Perspective

- Based on our country allocation models, our international equity strategy has maintained a below benchmark weight in Japan for the last several quarters.
- Depending on risk level and mix of assets, Bailard's globally diversified clients likely hold a relatively small approximately 1% to 3% of their total portfolios in Japanese equities.
- While the Japanese market as measured by the Nikkei 225 index declined more than 16% in local trading on Monday and Tuesday (March 14th and 15th), in today's U.S. trading, Japan-tracking exchange traded funds were relatively flat, indicating a possible strong bounce-back when the Japanese stock market opens this evening.
- We are monitoring this situation very closely to seek either downside protection or upside opportunity.

Japan Perspective

SHORT-TERM

- Japan currently generates almost a trillion kilowatt hours of electricity annually compared to a consumption of under 900 billion kilowatt hours. Japan therefore generates excess power of about 11% per year.

- Nuclear power makes up about 25% of total power generation in Japan. The four reactors that have been shut down represent only 5.6% of this capacity or less than 1% of total Japanese power generation.
- In the short term, the most critical issues are, of course, the feeding and housing of thousands of displaced residents of the nearby region. Business in the region will be affected for months as initial infrastructure is restored and debris is cleared.

LONG-TERM

- Initial damage reports from the tsunami and the earthquake point to a minimum of five years of reconstruction. Besides manufacturing capability, houses, roads and power grids will require extensive work.
- Japan is the world's third largest market for construction, so it should have the capability to perform much of the reconstruction work without international partners.
- While Japan is the world's second most indebted sovereign nation with more than a 200% debt to GDP ratio, most of that debt is owned by Japanese citizens, reducing the burden. The interest cost on this debt is also low by global standards. This suggests that Japan has the fiscal strength to take on further debt to assist the rebuilding effort.
- The yen rose 20% in the three months after the Kobe earthquake of 1995, as Japanese capital that had been invested overseas returned home to assist in the rebuilding effort.

Japanese investors have continued to diversify internationally over the sixteen years since then. As a result, an even larger percentage of assets relative to Japan's GDP is currently invested overseas. Thus, the yen has the potential to appreciate significantly as some of that capital is repatriated to assist in the reconstruction and recovery efforts.

- Any positive impact on Japan's economy from reconstruction is unlikely to be felt until late 2011, at the earliest.
- While inflation hasn't been seen in Japan in decades, the potential repatriation of capital, the central bank's massive infusions of short-term liquidity and longer-term rebuilding stimulus by local and federal agencies (as well as private corporations) are likely to generate an increase in the price level. This could be positive for Japan's economy in the long run.

Charities active in supporting relief efforts include Global Giving (<http://www.globalgiving.org/projects/japan-earthquake-tsunami-relief/>) and Save the Children (<http://www.savethechildren.org>). Bailard offers these organizations as examples only.

Sources: Reuters, Wikipedia, Bailard Research

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