

Thesis Reaction

15th March 2011

Financial implications of the Japanese earthquake

Notwithstanding the appalling human tragedy of the Tohoku Pacific Coast earthquake, the key question now for investors is, how serious will the longer term consequences for the Japanese economy and stockmarket be?

Historical context

The last major quake was at Kobe in January 1995. It caused \$100bn of damage and industrial production in the affected region fell 4.6% in the following month on month figures - but then rebounded 4.9% m/m in February. Similarly, whilst there was an immediate hit on GDP, this then advanced by 0.9% in the next two quarters as rebuilding and consumer spending (replacing destroyed property and consumables) rebounded strongly. The net effect was a 2% hit on GDP that year. However it should be borne in mind that property destroyed doesn't count as a negative on GDP figures, but replacement is included as a positive. The equity market did fall heavily afterwards, but this was in the context of an already weakened economy and fragile corporate balance sheets. In some respects, therefore, cataclysmic events can be the trigger for an overdue reality check, as was last seen with 9/11.

The economic impact

Initial reaction from economists is a 3% hit on GDP. The affected region is far enough away from the heavy concentration of industry and manufacturing (i.e. in greater Tokyo) that the overall economic impact should not be that significant, i.e. it contributed only around 6%-7% of total GDP. However, because it trades actively with other regions, the wider impact may be greater than with the Kobe earthquake (i.e. a different region where the impact was more localised).

The equity market

After a very short opening last week the market (i.e. the Nikkei 225) fell over 6% yesterday after the first full day's trading, with insurers, autos, steel and chemical stocks suffering the brunt of selling, whilst construction and consumer related stocks will benefit. Unlike when the Kobe earthquake struck, this time corporate profits had been slowly recovering, and it is therefore much too early to forecast the medium to longer term impact on corporate profits. The immediate concern is of course developments at the two nuclear plants, particularly Fukushima. Following on from this will be the duration of the loss of power to industry - if this is restored sooner than expected, markets should rally. In the meantime one can never underestimate the psychological impact of these types of events, regardless of valuations. Overseas investors, in particular, had been increasing positions recently, and some may have a change of heart if the recovery process shows signs of stalling. Relative to Japan's stockmarket weighting in the FTSE World index we have been nearly two thirds underweight for the last couple of years. Until the picture is much clearer, we will not be changing this position, but will of course be keeping it under active review.

The currency

Post the Kobe earthquake the yen rallied as Japanese investors, insurers, government and industry undertook a massive repatriation of funds. This time, whilst insurers will no doubt be recalling assets, balanced against this most local investors are currency hedged, the government is keen to stop the yen appreciating and overseas investors may become heavy sellers. Consequently we envisage a period of volatility with no significant breakout in either direction. Last month we took a strategic decision to hedge all clients' Japanese equity exposure and we see no reason to change our view based on the latest information available.

Bonds

Any negative impact on economic growth can benefit, particularly sovereign, credit markets unless there are also fears of downgrades and/or default. Whilst prices of government bonds (JPYs) were little changed, those of credit default swaps (CDS) on JPYs jumped 20%, perhaps remembering that Turkey defaulted in 1999 (although Chile and New Zealand did not). Credit ratings agencies had in fact already turned mildly negative prior to the earthquake (mainly on concerns at the lack of political cohesion in taking decisive action on the economy). The likely outcome is an extended period of fiscal easing, meaning that yields are likely to remain close to current levels unless the financial position proves to be far more serious. We do not have any direct exposure to Japanese bonds.

Impact elsewhere?

Share prices of affected insurers have fallen heavily over the last couple of days; most Lloyd's insurers, for example, are likely to be impacted to the tune of 10%-15% of net asset value. On a positive note this could facilitate a recovery in disaster premiums. On the energy front, gas prices will probably rise as demand increases to replace lost domestic capacity (BG up around 4% today). Strong supply lines should limit the upside, however, unless the disruption heads well into next year.

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