



Rapid response note

Briefing on Japan

16 March 2011

STANDARD LIFE INVESTMENTS



Summary

Firstly, we must remember that the recent events in Japan are an enormous human tragedy. Our sympathies naturally lie with the millions of people who have been affected. It is clear that the situation in Japan is extremely unsettled and the response by corporates, households and the government very uncertain. Nevertheless, we

can begin to scope out the extent of the damage caused to the Japanese economy and the likely timescale for recovery. The major uncertainty at this moment in time, and the significant difference from Japan's last major earthquake in Kobe in 1995, is the extent of the damage to the energy sector and the length of time it may last.

The immediate impact

- The Tohoku Pacific earthquake and subsequent tsunami are the largest disasters affecting Japan since World War II, exceeding, for example, the Kobe earthquake (only 7.3 magnitude, compared to 9.0 on the logarithmic Richter scale). Kobe's costs were estimated at ¥5-10 trillion (approximately \$100 billion) while some initial estimates of this disaster are as high as ¥15-20 trillion. Nomura estimated that 1.0-1.5% of Japan's capital stock has been affected vs 0.8% for Kobe.
- The economic impact of the disaster will be very noticeable on Japan. The worst affected local economy accounts for about 6-7% of Japan's nominal GDP. Early estimates suggest the cost of the earthquake/tsunami

could be above 2% of GDP from lost production in March-May. It is highly likely that second quarter GDP will be negative, after a flat to negative outcome for Q1, which followed the loss of output seen in Q4. Consumer confidence figures are expected to slide dramatically. Accordingly, it will feel like a double-dip recession in 2010-11 even if technically it may not be one.

- The Kobe disaster is useful as an example of the length of time this sort of event has on the economy. After an initial disruption for some quarters (a 1-2% annualised fall in GDP) there was a lengthy reconstruction phase over 1-2 years as the re-building began.

Differences from Kobe

- One important difference from the Kobe earthquake is the impact of this disaster on the energy sector, which could be long lasting. On some estimates the capacity to produce electricity has been reduced by as much as 40%. At the very least a number of nuclear reactors have been shut down – nuclear power accounts for 35% of electricity production and the affected area 20% of this. Large parts of the country could face short-rolling power cuts well into April. Similarly, a large part of Japan's refining capacity has been damaged or disrupted. This could affect not only Japan but the Asian region; for example, Japan is a net exporter of diesel.

- The other immediate concern is the potential for a historic nuclear catastrophe. Events remain extremely uncertain at the time of writing. Longer term, however, this disaster will lead to a re-think of Japan's dependence on the nuclear industry. Safety levels at old/new reactors outside Japan will need tightening. Several countries, including Germany, have already announced delays or reviews. In order to overcome such energy disruptions, Japan could require more coal and especially LNG going forwards. It is by far the world's largest importer of LNG. Prices are already starting to respond.

The policy response

- The authorities have already stepped in to support the economy, with the Bank of Japan (BoJ) announcing three immediate measures: gensaki repo operations of ¥2-3 trillion, ¥15 trillion of liquidity injections to counter the risk of stalled fund transactions in the short-term money market, and an expansion of its risk assets programme – essentially a version of QE – from ¥35 to ¥40 trillion (another ¥500 billion for long-term JGBs, ¥1 trillion for treasury discount bills, ¥1.5 trillion for CP, ¥1.5 trillion for corporate bonds, ¥450 billion for ETFs, and ¥50 billion for J-REITs). There is already cross-party support for a fiscal package, with sums of up to ¥5 trillion being talked about (about 1% of GDP – Kobe's package was about ¥3 trillion). Details remain hazy though, i.e. the amount of JGB issuance or a special tax increase. This will matter for the shape of the yield curve.

- Some investors are worrying that the disaster could push Japan back into another period of deflation. Undoubtedly this is possible, but the resulting policy response would be important. The BoJ could react much more forcibly, increasing and expanding its QE. Between 2001-06, the central bank boosted the monetary base from 14% to 22% of GDP, which in turn helped create modest growth in the money supply and a deceleration in deflationary trends. One trigger to monitor will be the BoJ's response if the yen begins to appreciate, i.e. does it begin to undertake currency intervention. The monetary response will be important; depending on the eventual fiscal response, more questions may be asked about the long-term fiscal imbalances facing Japan, e.g. a structural budget deficit of some 6% of GDP, and a debt/GDP ratio of some 200%.

The market response

- The financial markets have partially reacted to the disaster. Hence the Nikkei index has fallen about 20% (N.B. the Kobe market fall was 8% in five days). However, our analysts report that many business-specific factors and details remain uncertain. Further company and sector changes in the Nikkei should be expected. Multiple sectors need examining including: insurance (paying for the damage), construction (benefiting from re-building), energy, technology and industrials (damaged capacity), and banks (dislocation from the hit to normal payments plus bad debts).
- So far the yen has moved little. The reason may be that the financial impact of the disaster is uncertain. On the one hand, overseas investors may pull money out, due to safe-haven flows. On the other hand, insurance companies and the government may repatriate assets from overseas e.g. US Treasuries in order to meet domestic financing requirements. Reportedly, Japanese insurance companies hold 12% of their assets in foreign securities. The BoJ has previously indicated ¥80/\$ is a level it wishes to protect; that seems likely as any move above this level could lead to unruly markets and large asset price movements. Consequently, currency intervention remains a possibility. N.B. while the yen did appreciate after the Kobe disaster this partly reflected a trade dispute with the US.
- The external impact of the disasters should be limited at the macro level but could be much larger at a company level outside Japan. Assessments of US or Chinese trade flows with Japan suggest the disaster should cause no more than a few months' disruption to trade and output. Excess capacity should allow other producers to benefit. In GDP terms, Japan accounts for 6% of global GDP, so on the assumption that its GDP falls by as much as 3%, as a consequence of the earthquake, this would take about 0.2% off global GDP.
- At a sector level, just-in-time delivery and tight supply chains could mean that certain industrial firms, say in autos or electronics, could suffer problems in other countries. It is reported that Japan accounts for 20% of world semiconductor production and 40% of flash memory, used in anything from smart phones to tablets or computers. Such disruption could have a noticeable impact on Asia due to the tight trading links. Looking at particular sectors, a few factors can already be identified. Re-insurance is generally expected to face large losses, although past experience shows that such firms regain pricing power and profitability within a year or two and the information so far suggests this is not (yet) a capital event. The energy sector remains very uncertain as described earlier. Japanese tourism both from and to Japan could be affected for some time – radiation coverage in the media is already causing some national governments to advise foreigners to leave immediately.

The House View

The House View has been Light in Japanese and Asian equities. The GIG will consider when and how to alter its position – further details will be provided in the next edition of Global Outlook.

Disclaimer: This Market Commentary is provided by Standard Life Investments Limited for general information purposes only and represents the opinion of the author based on market conditions at the time of writing, which are subject to fluctuations. Nothing in this document represents investment advice of any nature whatsoever, and it does not constitute an offer or solicitation to

purchase or sell any financial instruments. Accordingly, to the extent permitted by applicable law, Standard Life Investments Limited does not accept any liability or responsibility for the information contained in this Market Commentary or any investment decision or other action you may take in reliance upon the information contained in this Market Commentary.

www.standardlifeinvestments.com

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. The Standard Life Investments group includes Standard Life Investments (Mutual Funds) Limited, SLTM Limited, Standard Life Investments (Corporate Funds) Limited, SL Capital Partners LLP and AIDA Capital Limited.

Standard Life Investments Limited is authorised and regulated by the Financial Services Authority. Standard Life Investments (Hong Kong) Limited is licensed with and regulated by the Securities and Futures Commission in Hong Kong and is a wholly-owned subsidiary of Standard Life Investments Limited

Standard Life Investments Limited (ABN 36 142 665 227) is incorporated in Scotland (No. SC123321) and is exempt from the requirement to hold an Australian financial services licence under paragraph 911A(2)(l) of the Corporations Act 2001 (Cth) (the 'Act') in respect of the provision of financial services as defined in Schedule A of the relief instrument no. 10/0264 dated 9 April 2010 issued to Standard Life Investments Limited by the Australian Securities and Investments Commission. These financial services are provided only to wholesale clients as defined in subsection 761G(7) of the Act. Standard Life Investments Limited is regulated in the United Kingdom by the Financial Services Authority under the laws of the United Kingdom, which differ from Australian laws.

Standard Life Investments Limited, a company registered in Ireland (904256) 90 St Stephen's Green Dublin 2 and regulated in the UK by the Financial Services Authority.

Standard Life Investments (USA) Limited, registered as an Investment Adviser with the US Securities and Exchange Commission Standard Life Investments Inc., with offices in Calgary, Montréal and Toronto, is a wholly owned subsidiary of Standard Life Investments Limited.

Calls may be monitored and/or recorded to protect both you and us and help with our training. www.standardlifeinvestments.com © [2011] Standard Life, images reproduced under licence