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JAPAN'S MARCH 2011 EARTHQUAKE, TSUNAMI & NUCLEAR CRISIS

– SOME THOUGHTS FOR AUSTRALIAN INVESTORS

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Japan’s March 2011 earthquake, tsunami & nuclear crisis – some thoughts for Australian investors

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This note addresses some of the likely implications for Australian investors of the recent triple disaster in Japan – the earthquake, tsunami and nuclear crisis.

Summary –

- **Short term** – little impact. All types of investments in all markets across the world (including shares, commodities, precious metals, currencies, bonds) reacted suddenly amid a frenzy of panic selling, but they quickly recovered in the subsequent week or so. It was little more than another opportunity for long term investors to profit from panic-sellers.
- **Medium term** – the crisis will probably not be enough to trigger major policy changes in Japan – like the oil shocks of the 1970s, which shifted the national focus away from heavy engineering toward manufacturing small high-quality, fuel-efficient cars and consumer electronics. This time, no major policy changes are likely. Probably the only global impact in the medium term is likely to be in energy markets, with a shift away from nuclear toward coal/gas and green alternatives.
- **Long term** (multi-decade) – little impact. The current crisis is unlikely to have any major impacts on the long term direction of Japan, or its role in the region or the world - unlike the Meiji Restoration in the 1860s, or the reconstruction of Japan after the Second World War, both of which had long-lasting fundamental impacts on Japan, the region and the world.

Japan is a nation of stoic and resilient people. Tsutomu Yamaguchi survived both the Hiroshima and Nagasaki nuclear bomb blasts. Not only did he live to tell the tale, he lived for another 65 years, only passing away in January 2010. He was working for Mitsubishi in Hiroshima on 6th August 1945 when America dropped the “little boy” nuclear bomb that destroyed the city and incinerated more than a hundred thousand civilians. Although Tsutomu was only two kilometers from the epicenter of the blast at the time, he survived and managed to make it 200km back to his home in Nagasaki. As he arrived home on 9th August, the Americans dropped the “fat man” nuclear bomb on Nagasaki, but again he survived (although the rest of his family perished).

Tsutomu was the only “nijyuu hibakusha” – survivor of two nuclear bombs, but about 250,000 civilians were incinerated in the blasts, and countless millions suffered radiation-induced cancers and other ailments and deformities in the many years following the attacks.

Hiroshima and Nagasaki were man-made disasters, but Japan has also been beset by a raft of natural disasters throughout its history as it sits in a prime earthquake zone on the edge of a major crack in the earth’s crust.

On 11th March 2011 a massive earthquake off the northern coast of Japan’s Honshu Island caused a devastating tsunami that destroyed large areas around the nonrthern city of Sendai, laying waste to cities, towns, farms and infrastructure. Among the damaged structures were three of the reactors in the Fukushima Dai-ichi nuclear power plant, 250 km north of Tokyo. In addition, there are broader fears of further nuclear meltdowns and radiation leaks as a result of power failures affecting cooling facilities in other reactors.

The crisis in context

The human toll is as yet unknown, but may well exceed 40,000 or even 50,000 people. Sad as it is for anyone to die, the recent disaster is relatively minor compared to the loss of life in the Japan's two "big ones" – the earthquake on Hokkaido Island in 1730 which killed 137,000 people, and the Kanto quake in 1923 which destroyed Tokyo and Yokohama and killed 142,000.

Compared to Japan, China has suffered much more from natural disasters, and from earthquakes in particular. Approximately 830,000 Chinese were killed in a quake in Shansi in 1556, about 200,000 were killed in Gansu in 1920, another 200,000 in Nan-Shan in 1927; approx 500,000 to 600,000 were killed in the Tangshan quake near Beijing in 1976, and 69,000 died in the Sichuan quake in May 2008.

Outside of China and Japan, there have been many other devastating earthquakes and tsunamis that have had much greater impact on the economies of the countries affected. In the past few years alone we have had the quake off the coast of Sumatra on Boxing Day 2004 which killed some 300,000, the earthquake in Kashmir in October 2005 which killed 90,000, and the quake in Haiti in January 2010 which killed approximately 250,000 people.

Although the destruction in the recent Japanese disaster is minor relative to these much larger events elsewhere, the difference for investors is that Japan is the world's 2nd (or recently the 3rd) largest economy, so investors tend turn their attention to the likely impacts on investment markets.

Short term impacts on Japan

The earthquake in Kobe, Japan in January 1995 killed 6,000 people but it had more impact on the Japanese economy than the recent Sendai disaster is likely to have, as Kobe was a major manufacturing centre and the world's 6th busiest trading port. However, the Japanese economy bounced back very quickly from Kobe - Japanese GDP growth was 1.9% in 1995, up from just 0.9% in 1994.

Although the Sendai region is not a major industrial area, power outages are disrupting production all over Japan. Early estimates are that Japanese output may be several percentage points lower this year, but economic activity is likely to pick up quickly as the re-construction program gets under-way in the coming months. This would make it similar to the pattern in the GFC – ie a sharp fall followed by a rapid re-bound. This time the reduction in domestic demand for consumer goods would largely be offset by a surge in demand for resources and materials required for the re-construction.

The government's early estimates of the damage bill were around $60 billion, but the total costs may eventually reach $200-300 billion, which would be around 3% to 4% of GDP – ie 3% to 4% of just one year's national income. Spending money on re-building lost assets results in a direct permanent loss to Japanese wealth.

Can Japan afford it?

Most of the costs of the re-building effort will be borne by the Japanese government. Although the government is already heavily indebted (with government debt levels of more than 200% of annual GDP) this is no higher than the government debt levels in the US, UK and Western Europe (and in Australia, for that matter) during the 1930s depression and 2nd World War. The re-building effort would be similar (although much smaller in scale) to a war-time build-up or post-war reconstruction, and government debt financing for major spending or re-building programs is not unusual.

The Japanese government has the capacity to issue more debt and almost all of it will probably be bought inside Japan. Half of all Japanese government debt is held by other Japanese government agencies and another 40% of it is held by local Japanese households, pension funds and banks. Less than 10% of all the outstanding Japanese government debt is owned to foreigners. Japanese households are sitting on around $17 trillion in savings and they can easily buy a couple of hundred billion dollars more in government bonds (or even donate the amount out of their savings) to help rebuild their stricken country. $300b represents less than 2% of household savings. No other country is in a better position than Japan to come up with $300b in savings (if that is the final cost) to pay for the damage.

The very low interest rates (around 1.2% pa for 10 year debt) mean that servicing the interest burden is manageable. If the interest burden rises relative to tax revenues, the government can simply print more money to repay its Japanese bond holders, so there is little need for default. This lack of default risk premium in the pricing of Japanese government bonds has been keeping bond yields at very low levels for many years. Any inflationary consequences of money-printing (higher consumer prices and a weaker yen) would be welcomed by the Japanese central bank and government as positive outcomes.

Global setting before the Japanese crisis

January and February of 2011 were generally good for global markets. Corporate earnings were improving, commodities prices and bond yields were edging up, reflecting a general optimism about the prospects of global growth, with deflation fears receding. Precious metals prices were rising as a result of mounting fears of impending inflation as the US, UK and European governments continue to print money in an effort to debase their currencies to stimulate their debt-laden economies. Oil prices were heading up due to rising demand in China and India together with fermenting unrest in the Middle East, resulting in profit surges in the big oil companies, which are the biggest listed stocks in the world.

Some of the key dates in the unfolding crisis were as follows:

Key dates – Middle East:
- Fri 17 December 2010 – civil riots begin in Tunisia
- Fri 14 Jan 2011 – ousting of Tunisia’s President Ben Ali
- Wed 2 Feb – first mass protests in Cairo
- Sat 5 Feb – first mass protests in Saudi Arabia
- Friday 11 Feb – Egypt’s Mubarak resigns
- Thurs 17 Feb – “Day of Rage” protests in Libya
- Friday 18 Feb – Benghazi (in eastern Libya) claimed by rebels, Yemen’s “Friday of Anger”
- Wed 22 Feb – Gaddafi vows to fight to the last drop of blood
- Friday 25 Feb – UN imposes sanctions on Libya
- Friday 4 March – Gaddafi starts fighting back & regaining territory
- Friday 11 March – “Day of Rage” protests in Saudi Arabia
- Thurs 17 Mar – UN approves attacks on Gaddafi
- In addition, there were escalating riots and marches all across North Africa and the Middle East – in Algeria, Mauritius, Morocco, Djibouti, Bahrain, Iran, Iraq, Jordan, Oman and Syria.

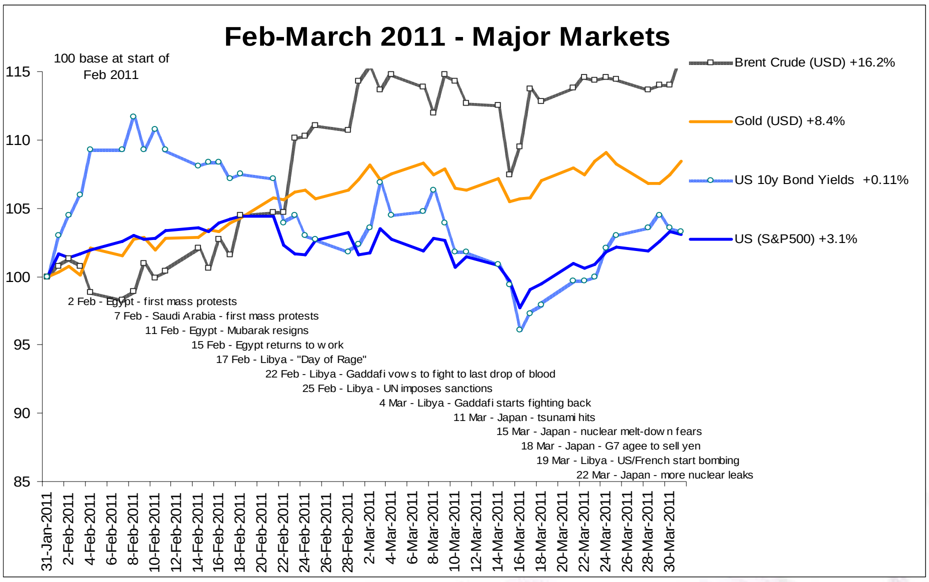
Key dates – Japan:
- Friday 11 March – tsunami hits Japan
- Tuesday 15 March – nuclear melt-down fears escalate
- Friday 18 March – G7 agree to sell down yen
- Wed 23 March – further nuclear leaks found

Short term impacts

The triple disaster of the earthquake, tsunami and nuclear meltdown fears in Japan, coming on top of the widening strife in the Middle East and the continuing government debt problems in Europe, resulted in sudden jolts in the prices of virtually every type of investment asset, not just in Japan but around the world – shares, gold, oil, metals, rural commodities, currencies, and bonds. Bonds jumped in price as investors panic sold everything else and retreated to the “safety” of government bonds. Almost all of the sudden price moves were pure knee-jerk reactions and were quickly reversed after just a few days.

The first chart shows the impact the events of February and March on the prices of oil and gold, US shares and on US government bond yields, which can be viewed as indicators of investor confidence in the outlook for global economic growth.

Chart 1



In the first half of February investors were optimistic. The Middle-Eastern crisis was looking like following a relatively peaceful path after the speedy hand-overs in Tunisia and Egypt, and there were positive results in the corporate reporting seasons in the major world markets. The peak was on the 18th February with the fall of Benghazi to rebels in Libya.

However, the optimism soon wore off as Colonel Gaddafi dug in and started to fight back in Libya. The situation and investor sentiment steadily deteriorated until disaster hit Japan on the 11th March, when the panic selling accelerated. The bottom was the middle of the week after the tsunami, but sentiment improved rapidly with the G7 agreement on the yen, and the UN Security Council resolution approving the use of force against Gaddafi, both taking place on the 18th March.

Immediate impacts - Australia

January was not a good month for Australia. Flooding had caused massive widespread damage throughout Queensland, costing around $30 billion in damage to property, crops and infrastructure, and 35 lives were lost. In addition, Cyclone Yasi hit on 2nd February, capping off a disastrous summer for Queensland. Australian shares were flat overall for January and commodities prices were up, primarily due to supply shocks in the rest of the world, not just as a result of the floods in Australia.

February was half-year profit reporting season in Australia and the results were decidedly positive, with most companies increasing earnings strongly and many also increasing dividends. The next chart shows the Australian dollar, Australian shares and Australian government bond yields from the start of February.

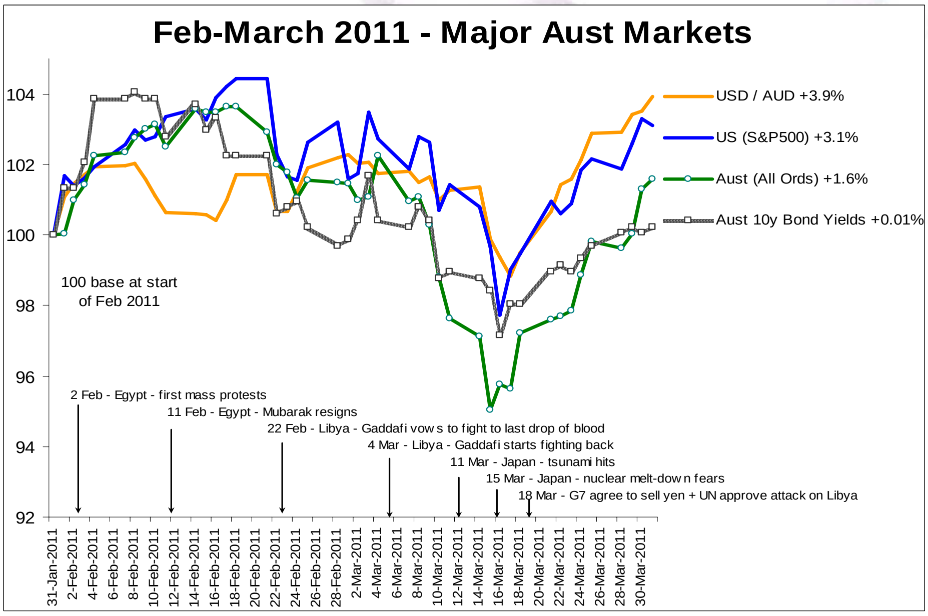


Chart 2

This shows that the pattern was very similar to the previous chart.

Optimism dominated markets in early February, but pessimism took over from mid February and into March, then prices dived when the tsunami struck, but quickly bounced back. The Australian dollar, Australian bond yields and share prices all bounced back quickly (US share prices are also shown here for comprison)

Stock markets

Stock markets in developed markets were rising strongly in January and early February on strong profitability growth in most major companies, even in Japan. After the high on the 18th February, the optimism and share price gains stopped when Gaddafi made his "fight till the last drop of blood" speech on the 22nd Feb, and stock prices weakened over the rest of February and into early March.

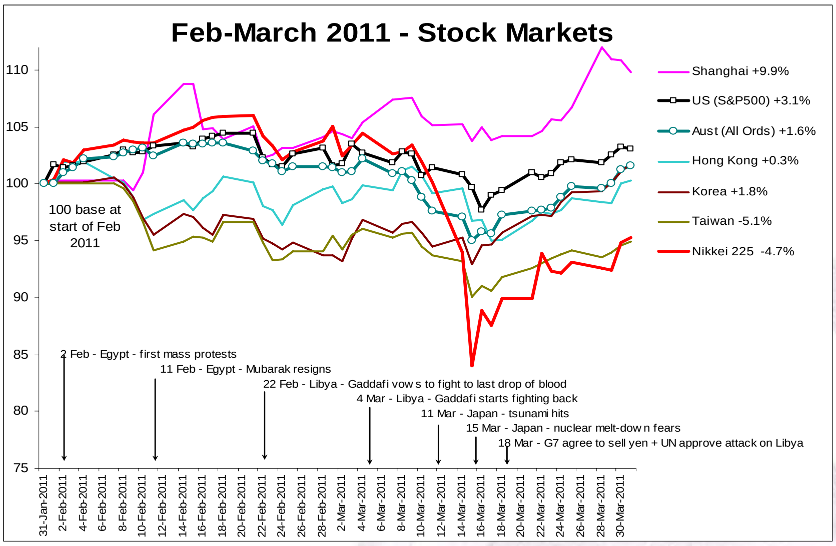


Chart 3

When the tsunami hit on the 11th March, investors dumped Japanese stocks. But investors also dumped stocks everywhere else in the world in a general panic that lasted until the 15-16th March.

From the top in mid February to the bottom in mid March, the Japanese stock market fell 20%, but the US market fell 6%, UK fell 8%, Germany fell 12%, and Australia fell 8%. Chinese, Taiwanese and South Korean markets did not fall as much as they were already weak in January and February, due to mounting concerns about a possible hard landing in China.

As investors realised that the panic was an over-reaction, shares quickly returned to their pre-February levels in almost all cases. Japanese stocks of course are directly affected and remain 7% lower than at the start of February (and 9% below their mid-February highs), but other markets (except Taiwan) have fully recovered in just two weeks, as shown on the above chart. Not shown on the chart are UK and Germany, both of which are also back to their levels at the start of February.

After the re-bound, Japanese stocks are still 9% below their pre-tsunami levels in mid February, but this still doesn't make much sense. Most Japanese stocks were not over-priced before the crisis (trading at around 11 times next year's expected earnings on average), and it is highly unlikely that future revenues, earnings and dividends of all Japanese companies will now suddenly be 9% lower in perpetuity due to the crisis.

Currencies

The tsunami also had a sudden impact on currencies. The following chart shows the path of the yen and the Australian dollar, which were the most volatile currencies during the crisis.

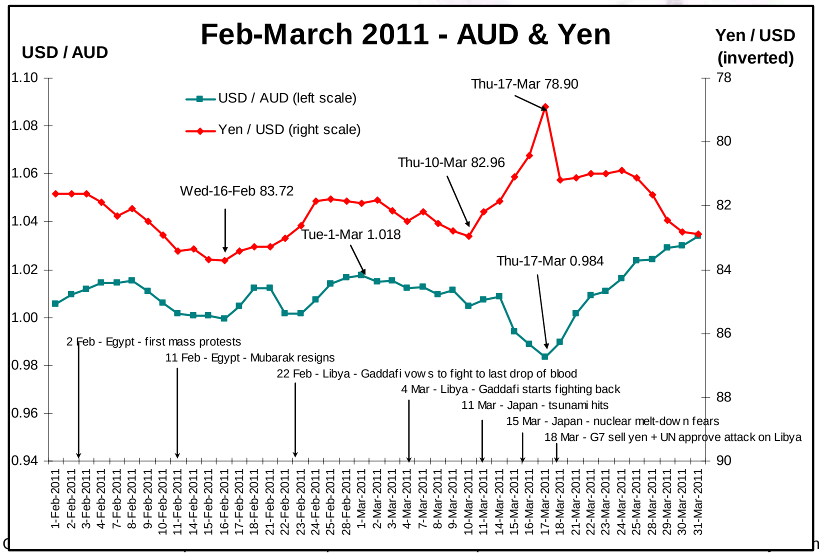


Chart 4

Low inflation, growth and interest rates have kept the yen strong since the Japanese economy hit a wall in the early 1990s, and especially since the GFC, and the high yen has been a major obstacle to economic recovery.

When the tsunami hit, the yen immediately shot up further, for two main reasons. The first was in anticipation of Japanese households, companies, and government agencies having to sell foreign assets and buy back yen to bring

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