# MARKET COMMENTARY - JAPAN

RMB ASSET MANAGEMENT

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A 9.0 magnitude earthquake occurred off the north-eastern coast of Japan on 11 March (Friday). This is the largest earthquake ever recorded in Japan and Prime Minister Naoto Kan has said the nation is facing its sternest test since World War II as it tackles the aftermath of an earthquake, tsunami and a growing nuclear crisis. Thus far 1,500 bodies have been found, but estimates of a final death toll are up to ten times this figure.

The affected region's economy is approximately the same size as that of the area hit by the Kobe earthquake in 1995. It is likely that the short-term economic impact of the recent earthquake will be greater than in 1995 due to the significant disruption of road networks, power plants and other infrastructure over a wide area that was principally caused by the tsunami.

At this stage it remains impossible to confidently comment on the scale of the damage that has been caused in Japan as a result of Friday's events. The present situation remains too complex to quantify with any certainty. As we write on Tuesday morning, we can report that the market session overnight in Japan saw further falls in the stock market as the risk of a nuclear incident in Japan escalates. The Nikkei closed this morning down -10.6%, having risen from its intra-day low of -14.5%. Following a third blast and fire overnight at the Fukushima Daiichi nuclear plant fears are rising about a significant radiation leak.

**Nuclear risks**

The Fukushima nuclear power plant has experienced three explosions since the earthquake and tsunami struck last week. The blasts were caused by a build up of hydrogen gas rather than the nuclear material directly. Tens of thousands of people have been evacuated in order to form an exclusion zone that is 20km in radius from the plant. Reassuringly, the three operational reactors at Daiichi power station shut down automatically as the earthquake was detected. Despite this, the nuclear fission taking place will require time to abate. In the meantime it is imperative to continue to cool the reactor and it is this which is proving difficult. The tsunami has knocked out the backup diesel generators that are designed to pump water to the core. In an effort to keep the reactor cool, it has been flooded with seawater. There is a significant, and growing, chance that one or more of the reactors will begin to meltdown, as the heat generated by the exposed fuel melts the rods themselves along with the casing of the reactor, releasing molten radioactive material. Despite this risk, experts do not believe that a catastrophe on the scale of Chernobyl is likely due to the higher quality construction used in Japan.

**Economic opportunity**

Prior to the earthquake, Japan's economy was in a stable position. Japan's longer term issues, however, have been well documented; most notably the unfortunate demographics, poor GDP growth, little or no inflation (and at times deflation) and outstanding public debt which is a multiple of GPD. Indeed with a ratio approaching 220%, the debt to GDP imbalance in Japan is twice as bad as that of Greece. In the aftermath of the natural disaster, there are inevitable costs for the government both in terms of rebuilding the affected areas and also in shoring up confidence in the Japanese stock market. The rebuilding required now will reduce the likelihood of a much needed fiscal consolidation in the short term.

Overall, Friday's earthquake has caused significant humanitarian hardship, but it has also had a significant economic impact on Japan. Whilst no direct extrapolations should be made from the aftermath of the Kobe

*Sources: Bloomberg, Nomura, Goldman Sachs, Financial Times, Polar Capital. March 2011*

earthquake in 1995, it does provide a useful reference point. An optimistic scenario is that this catastrophe spurs rebuilding and reinvigorates economic activity in the affected regions. History suggests, however, that to be too bullish on the economic recovery is unwise: the experience post-Kobe suggests that a V-shaped recovery supported by a rapid upturn in demand driven by government-funded rebuilding work in the affected areas is unlikely. At the same time, a slump in the domestic economy caused by the earthquake seems overly pessimistic.

It is reasonable to assume that the Japanese economy will experience difficulties in the short term, but these pressures, whilst significant, should not be disastrous. In 1995, for example, the reduction in economic activity was temporary, with production transferred to alternative sites. Whilst production fell by 2.6% in January 1995, it had recovered to pre-disaster levels by March of that year.

One reason that this event is dissimilar to the Kobe earthquake is the impact on key infrastructure. It is this which may result in a more severe short term impact on the economy in this instance. Importantly, the physical damage to ports in the north of the country does not include any major trade hubs. Other ports are expected to substitute for any lost capacity. Japanese companies in general are at very low capacity and in the long run, these events may prompt the creation of a leaner economy. Of the carmakers, only Toyota and Nissan are located in the north, and neither have been severely impacted. It is anticipated that production could resume in two to three weeks.

The Bank of Japan (BoJ) has confirmed that it will supply significant amounts of liquidity to stabilise the markets. Furthermore, the BoJ is likely to respond robustly to those aiming to profit from the earthquake through speculation, using means such as short selling. The need for political unity may also benefit the ruling party, whose recent attempts to pass the budget for 2011 have proven difficult as a result of opposition.

Prevailing economic conditions and the equity markets have a natural resonance with one another, but it should not be assumed that challenging conditions for one necessitate problems with the other.

**Equity markets**

The impact that this event will have on the stock market is difficult to predict. In the post-Kobe aftermath the Nikkei fell by 8% over the course of the first five days, before rallying by 5% during the next ten days. Since the onset of the current crisis, markets have already fallen by circa 18% despite liquidity injections by the BoJ of 15 trillion yen aimed at providing liquidity and stability.

In 1995 the equity market fell by between 15 and 20% in the months following the disaster. We believe that the market has a number of differences today compared with 1995 including both fundamentals and valuations. For example, the current PE ratio is circa 14 times earnings, whereas in 1995 PEs were at 40 times earnings. Furthermore today's price to book ratio is below 1, whereas in 1995 it was over 2. There is likely to be a boost to infrastructure and related industries, but some insurers that have not properly underwritten their exposure could be impacted.

**The yen**

The current events do not seem to be a catalyst for a stronger yen, however, in the shorter term the currency has rallied. The disaster brings forward the prospect of government intervention, with the US expected to be more accommodating of BoJ intervention in the foreign exchange (FX) market. Other factors affecting the yen include (i) the impact of events on business and consumer confidence, (ii) lower Japanese investment in foreign assets, (iii) the acceleration of profit repatriation by Japanese companies, (iv) lower FDI. Japan is the world's largest foreign creditor and its borrowing is mainly funded domestically. In the short term it is likely to repatriate offshore funds for

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*Sources: Bloomberg, Nomura, Goldman Sachs, Financial Times, Polar Capital. March 2011*

reconstruction, which could benefit the yen. On a longer term view, the Japanese government would prefer the yen to weaken (as has been their policy stance of late) given the impetus that this should bring for exporting industries.

**Our exposure**

The portfolios that RMB Asset Management International manage generally have an underweight to Japanese yen which we have been holding since last year. Since the earthquake, the yen has actually strengthened a little, and therefore the underweight yen will have a moderate impact on performance. We are also underweight Japanese government bonds and these have rallied, with the 10 year yield falling to 1.22%. Finally, we are broadly neutral or a little overweight Japanese equity. Thus far, having only had two full trading days since the disaster, the Japanese equity market has lost more than 18%. We remain resolute in the belief that the market provides opportunities and good valuations. In many of our funds we make use of James Salter's Polar Capital Japan fund. We believe that a highly skilled manager such as James is able to opportunistically rotate the portfolio towards sectors that should benefit from the reconstruction of the region such as housing, steel and quality manufacturing and technology companies.

Overall, therefore, despite the human impact of last week's earthquake and tsunami, we believe that the tragic event provides may provide new impetus for Japan's economy and additionally, scope for judicious investors to benefit from opportunities in the Japanese equity market.

Our thoughts are with the people of Japan at this difficult time.

*Sources: Bloomberg, Nomura, Goldman Sachs, Financial Times, Polar Capital. March 2011*

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