News Flash

Crisis in Japan

The March Economic Review & Outlook will be released later this week. Because much of it was written prior to the Japanese earthquake, that event was not mentioned in the report. Following is a summary of Ronald Blue & Co.'s perspective on the crisis as of this date. While we realize the tremendous toll that this has taken on the people of Japan, this perspective is limited to the economic and investment repercussions of the crisis.

IMMEDIATE MARKET REACTION TO JAPAN

Stocks

- After having the weekend to better understand the scope of the damage that Friday's earthquake/tsunami did to Japan, the significant loss of human life there, and the potential for a catastrophic nuclear accident, most global stock markets sold off on Monday, with the Nikkei Index falling over 6% in its first day of trading since the earthquake.

  As a general rule, markets do not like uncertainty. The situation playing out in Japan certainly increases uncertainty and has implications for worldwide energy prices, debt markets, and the strength of the current global economic recovery.

  Overnight developments have not helped global equity markets. Indications of additional explosions at the crippled Fukushima nuclear power plant and the possibility of radioactive material release (with potential impact on heavily populated areas like Tokyo) have increased investor fears and uncertainty. The Nikkei was down over 10% on Tuesday, major Asian markets sold off nearly 3%, European markets are down sharply in mid-day trading, and U.S. futures markets are down approximately 2.5% pre-open.

- Over the short term, markets will attempt to price a "worst case scenario" for the disaster that is occurring in Japan, with fear and uncertainty driving most investment decisions. After the initial sell-off, markets may attempt to re-price as more facts become known. For instance, it may take several months, if not years, to determine the long-term ramifications on public health from the radiation leaks at Fukushima.

  Also, not all equity investments will suffer from these events. (For instance, the stock of Caterpillar, the world's largest construction equipment maker, was up nearly 2% on Friday, as investors believed the company would benefit from rebuilding efforts in Japan over the next several years.)

Bonds

- Japanese interest rates initially fell (and may fall further) over the short term as part of a flight-to-quality trade.

- The overnight news of additional explosions and possible radiation leakage at Fukushima has strengthened the global flight-to-quality trade. U.S. Treasury yields are down across the curve this morning, with German government bonds and the U.S. dollar also rallying.

Gold

- Gold prices rose to over $1,425 an ounce on Monday as risk-averse investors sought refuge in the metal. Today's trading has gold falling under $1,400 an ounce, as broad-based selling in commodities (oil, gas, silver all down by more than 3%) contributed to the sell-off.

Oil, Commodities

- Oil prices declined slightly Monday and are off more steeply today, as the market anticipated that demand would fall from Japan over the next few months and as some investors grew concerned about the global economic recovery in light of the devastation inflicted on Japan.

  Oil prices would likely be under additional downward pressure, if not for the influence of Middle East events. Armed conflict still rages in Libya with Gaddafi forces reclaiming some rebel-held territory. Saudi Arabian army intervention in Bahrain has also added to market worries over regional stability.

OUR PORTFOLIOS AND JAPAN

Our portfolios have been underweight to Japanese investments for many years, given the low growth prospects and relatively higher valuations. Currently, we estimate that less than 5% of our equity investments reside in Japanese stocks, where the sell-off has been the worst. The international money managers we use for developed international markets have approximately 10% of their holdings in Japanese stocks, which is less than half the MSCI EAFE Index weight of 21%. (The MSCI EAFE index represents 21 developed markets outside of the U.S. and Canada.) While our international investments are down, they are down less than comparable indices, given our underweight.

Our bond investments on average have been about flat through this crisis. Commodities have sold off due to the negative effects this disaster could have on global growth and demand for raw materials. Gold is also down due to fears Japanese investors will need to sell assets to fund reconstruction. Interestingly, the Japanese Yen is higher over the past several days, as investors believe offshore Japanese money will return home, putting upward pressure on the currency.

Clearly, earnings will be affected for many Japanese companies, given the devastation. For some companies, earnings may actually get a boost, given the additional work needed to repair the damage. We are not anticipating any sudden changes in our international holdings due to this event. Rather, we would expect some selling of companies where earnings will be impaired for a long time, and possibly some additions where opportunities have presented themselves in the way of higher earnings or lower valuations.

NEAR-TERM IMPLICATIONS FOR JAPANESE ECONOMY

- Japan's economic growth will undoubtedly weaken over the near term, partly due to economic shortages and infrastructure damage caused by the natural disaster. For instance, a wide range of manufacturers have been forced to shut down or cut production as a result of the earthquake.

- Electricity shortages are also a significant impediment to growth. (The Fukushima nuclear power station, where engineers are struggling to prevent complete meltdowns from occurring in multiple reactors, accounts for roughly 20% of Tokyo Electric Power Corporation electricity production.) Rolling blackouts have been discussed, and it will likely take a considerable amount of time to restore full electricity distribution given the damage to the grid.

- Economic growth may also be impaired by a decline in personal spending. Japan has a very high structural budget deficit. Consumers who are worried about long-term fiscal sustainability or higher tax rates (to finance the deficit and reconstruction) may choose to save, limiting or reducing consumer spending growth.

- If there is a "bright spot" in this disaster *(strictly from an economic impact standpoint, limiting the analysis to damage from the earthquake/tsunami and not taking into account nuclear meltdown considerations)*: The GDP share of the three most damaged prefectures is only around 4% to perhaps 7% of the entire Japanese economy. By contrast, the smaller Kobe earthquake in 1995 hit a much more industrialized area.

LONGER-TERM ECONOMIC IMPLICATIONS FOR JAPAN

- If history is any guide, this national tragedy should contribute to more of a V-shaped recovery for Japan. Reconstruction efforts should lead to rising economic growth rates.

- The bigger long-term uncertainties relate to Japanese debt and energy markets:

  Even before the earthquake, Japan was already burdened by a large amount of debt. Now, the country faces even deeper deficits (as a result of lost tax revenue and emergency spending measures) and higher public debt levels. The Bank of Japan has responded to this natural disaster crisis by providing a massive liquidity injection and may ease monetary policy even further in the months ahead. The response of the BOJ, while necessary, has inflationary implications. This means that both real yields in Japan and inflation risk premium may rise, increasing interest rates.

  Given the drama currently unfolding at the Fukushima nuclear power station, Japan (which currently relies on nuclear energy for roughly 30% of its power needs) may see a long-term structural shift away from nuclear power. The most immediate alternative for the rebuilding of Japan is further reliance on fossil fuel energy production. As demand in Japan recovers (and this demand is increasingly oil-driven), we may see yet another reason for upward pressure on oil markets.

GLOBAL POLICY IMPLICATIONS

- As stated, the earthquake (and potential for nuclear power catastrophe) in Japan will harm the country's economic growth over the short term. Because Japan is one of the largest economies in the world, the events unfolding there clearly have global market implications and could threaten the strength of the global economic recovery.

- From a policy standpoint, the situation in Japan will likely make global central banks prone to maintain their accommodative policies or ease further. For instance:

    - New Zealand's central bank cut interest rates in response to their own recent earthquake disaster.
    - The Bank of Japan has attempted to support the market with additional liquidity injections in the aftermath of the earthquake and will likely engage in additional forms of quantitative easing as the crisis unfolds.
    - The ECB (which indicated recently that they may raise interest rates to combat rising inflation) will likely postpone such a move.
    - Federal Reserve governors that had been advocating an early end to the QEII stimulus program will likely be less vocal in their criticism. Arguments may also be made by some advocating additional stimulus.

- A continuation of easy monetary policies in the U.S. would raise the risk of longer-term inflation taking hold, which in turn could contribute to additional pressure on interest rates.

- Another factor that could raise interest rates in the U.S. over the next 6-12 months is demand driven: If the Federal Reserve ends QE II in June and effectively exits the market as a Treasury buyer AND if the Japanese significantly slow their purchase of Treasury debt (or potentially sell Treasury holdings to fund reconstruction efforts in Japan), interest rates are likely to grind higher as the market finds a new clearing price for U.S. debt.

- Energy markets could see some structural change: There will be global investigations over the safety on nuclear power in light of the Japanese reactor situation. For instance, both the U.K. and German governments have already announced plans to review nuclear power safety measures. To the extent that the viability of nuclear power as an alternative energy source is questioned, the markets could increase their reliance on fossil fuels, driving up energy prices over time. Also, other alternative energy sources (wind, solar, thermal) may benefit from a potential shift away from nuclear power.