INVESTMENT UPDATE ON JAPAN

By Chris Taylor, Investment Director & Head of Research , Neptune Investment Management, London

Chris Taylor, Investment Director & Head of Research at Neptune, provides an update on the aftermath of the Japanese earthquake and its effect on the wider economy.

Industrial disruption: The earthquake has caused a number of plants to be shut down and has damaged Japan's transport and electricity infrastructures. For example, Toyota temporarily suspended production at all 12 of its plants – which accounts for 38% of its global output. Steel firms, which export approximately 40% of their output, have shut down one plant each on average, although this was primarily due to power outages rather than plant damage. Many plants are likely to re-open soon but given the initial power outages and the introduction of rolling blackouts, it is unlikely they will operate at full production. Furthermore, the rail and metro systems are operating at a maximum of 70% capacity.

Power generation problems: Parts of the transmission network have been destroyed and engineers have been busy checking the state of other power generation equipment to ensure that it remains intact. However, the headline issue has been problems at various nuclear power plants. About 30% of Japan's electricity is supplied by nuclear power and currently 9 of the country's 54 reactors are offline. This represents 5% of Japan's electrical need.

Financial implications: The Bank of Japan has reacted to the crisis by pumping approximately ¥20 trillion ($246 billion USD) into the financial system through the money market, asset purchases and bond buy backs. The Government is also likely to suffer a ¥1.5 trillion ($18 billion USD) bill via the Japan Earthquake Reinsurance Company and will have to pay for the rebuilding of public infrastructure, at a cost of ¥5 trillion ($62 billion USD). In the private sphere, the majority of citizens and companies will have to use their savings as only 7% of the population take out earthquake insurance.

Comparison with the 1995 Kobe earthquake: Including Osaka and Kyoto, the Kobe region accounted for 12% of Japanese GDP. The Sendai/Tohoku region that has been devastated by the recent earthquake accounts for slightly less – approximately 7-8% as it is primarily an agricultural area. Following the Kobe disaster, GDP fell by 2% before seeing a V-shaped recovery which was supported by oil trading at just $17-21 per barrel. The economic cost of the Sendai earthquake is unknown but there is likely to be a short-term GDP surge due to domestic reconstruction which then subsides with GDP becoming dependent on net exports and overseas receipts.

Summary and investment strategy: This is principally a humanitarian disaster which the Government will have to finance. This will add to their debt burden, further undermining the currency and making more downgrades likely. Additionally, given the number of households that will not be able to rebuild their homes and business, social and health expenditure will have to increase dramatically. For Japan's global multinationals, the temporary closure and lesser operating capacity of their domestic plants can be offset by sourcing from elsewhere across their worldwide operations. Domestic firms, however, will remain hard hit. In particular, defensive sectors such as railways and utilities have seen their infrastructures destroyed.

Our investment strategy remains being invested in industry-dominant global multinationals across a variety of sectors. These are firms focused on global growth which are likely to be able to side step the worst of the situation in Japan.

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