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INVESTMENT UPDATE ON JAPAN

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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.

Costs - Who pays what?

Estimates for the cost of reconstructing the Tohoku costal region range from Prime Minister Kan's ¥5 trillion to the ¥20 trillion forecast by the Japan Centre of Economic Research (JCER). If Kan is right, his figure of ¥5 trillion for the reconstruction cost is equivalent to 1.1% of Japan's Gross Domestic Product (GDP) and 0.55% of the existing stock of national debt. If the JCER is right, their ¥20 trillion estimate is equivalent to 4.5% of GDP and 2.2% of outstanding Government debt.

However, the Government Earthquake Insurance Plan is capped at ¥1.4 trillion ($17 billion USD) and reinsurers at ¥3 trillion ($36 billion USD). Moreover, 95% of the population does not have earthquake insurance, while those in the Government plan only get back 30-50% of the damage cost. The outstanding costs will need to be paid directly by private individuals and companies. Therefore, Government liability is relatively small compared to this year's total budgeted spend of ¥92.3 trillion.

With regard to the nuclear plant, the Government and the utility company operating the compromised plant are liable; the equipment supplier (General Electric built most of the Fukushima plant) is not liable. As yet, the likely expenditure with regard to the nuclear plant is unknown and this will depend on what the final damage is.

Foreign Currency Trends

The recent rally in the yen has been largely momentum-based, not a result of foreign asset repatriation. There has been a seasonal inflow in the run-up to the end of the financial year, which we believe will be reversed. The rally has been further reinforced by speculators who borrowed in yen to buy non-yen securities. When these securities fell in value, they closed their positions and bought back yen. The Japanese do not appear to be selling their foreign assets to allegedly fund reconstruction. As of last week, there was still a net outflow year-to-date of the yen and with Japan's financial year-end on March 31st, most companies' foreign currency deals have already gone through the books.

Only those individuals with foreign currency deposits – there is approximately $160 billion (USD) in Japanese banks – are likely to switch back into yen for reconstruction purposes. The Government does not need to liquidate foreign currency either as the likely cost so far is much too small. Companies, on the other hand, already have funds in yen and will probably use this opportunity to relocate even more of their production outside of Japan to avoid further earthquakes, tsunamis, power cuts and a declining population.

G7* Intervention

Given the yen's rally, the G7 decided to intervene to stabilize the yen, to which no members objected. They understand Japan's predicament and all of the Bank of Japan's monetary intervention has not been sterilized. This corresponds with our analysis: Japan is bust, the currency is overvalued and the only functioning parts of the economy are the large global multinationals. So the greater their profits, the greater Japan's tax take – with the multinationals' profits being the only way to lift the latter quickly – and a strong yen restricts this possibility.

Manufacturing & Transport

There is not much actual damage to the manufacturing and transport infrastructure. Rather, the bigger disruptions are coming from the electric power blackouts which are hitting the rail system the hardest, given that they are almost entirely run by electricity, and manufacturing. A ripple effect with regard to global supply chains and specialist parts made only in Japan is a possibility, but there are usually alternative suppliers, inventory can be as high as 4-8 weeks' worth and these plants are not destroyed – though they may potentially operate at reduced rates.

Government debt vs. savings

The corporates and individuals hold the bulk of the cash/savings, which is bigger than the debt, but they are persistent net sellers of Japanese Government Bonds (JGB).

Only the banks and life insurance companies are buyers, driven by their asset/liability mismatches. Can the government force them to buy JGBs? Only if the Government "nationalizes" the savings and prevents capital flight by legislation, but this will be virtually impossible to do given the current political fragmentation. The Government would have to discuss it first in any case, and at that point capital would flee the country, undermining the yen again.

Investment Strategy

We believe that the global multinationals are in the best position of all Japanese firms, whatever the final outcome. We maintain our conviction that the yen's appreciation is not sustainable and firms with high overseas capacity and sales will do best. We believe that the yen will fall – and will keep on falling – due to the country's indebtedness.

Source: Neptune Research & Bloomberg.

*G7 refers to the Group of Seven: the economic alliance of Canada, France, Germany, Great Britain, Italy, Japan, and the U.S.

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