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Japan



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When catastrophe strikes somewhere in the world and many lives are lost, and the human suffering is unbearable for all involved, questions about the economic cost of the disaster and the impacts on financial markets inevitably arise, and they require an answer.

There is always the danger that commenting on the economic and market impacts of an event such as the Sendai earthquake and the subsequent tsunami can be seen as trivialising the event; somehow downplaying the enormous human suffering. Nevertheless, there are consequences for the economy and for markets that require a considered response, without diminishing our horror and deep sorrow at the human cost of the catastrophe.

As this piece is being written, the official death toll in Japan stands at 3,373, and is expected to climb well above that figure. A series of explosions at the Fukushima Nuclear Power Plant has raised grave fears of a nuclear disaster. In the financial markets, share prices in Tokyo have now fallen by nearly 20% since the close of trade prior to the earthquake. Share prices across the region are also sharply lower today – particularly as developments at the nuclear plant have worsened. The yen has strengthened against the US Dollar, perhaps reflecting speculation about, rather than actual, repatriation of Japan's offshore assets.

It is too early for anything more than educated guesses to be made about the short-term negative impact on Japan's economic performance, not least because the extent of the radioactive leakage from the Fukushima plant is highly uncertain. According to estimates from Barclays Capital, the affected area accounts for over 6% of Japan's GDP, 6.8% of the population, and 7.2% of Japan's private sector capital stock. At this point, analyst estimates of the initial adverse impact on GDP are utterly unreliable, as are estimates of the likely boost to measured economic growth that will result from the repair and reconstruction work. That said, it is still worth noting that all such catastrophes produce both an initial adverse impact on recorded economic growth, and then add to measured growth as the recovery work gets underway. The timing and the magnitudes involved are of course uncertain and highly variable.

What follows is our assessment of what the catastrophe might mean for the Japanese, world and Australian economies, and how MLC portfolios have been affected.

For Japan, the broad impact of the disaster on growth is likely to follow the pattern outlined above, however, there are broader issues at work also. Japan's fiscal position is already dire, and the Government's share of the reconstruction and recovery effort is likely to put enormous pressure on the nation's finances. It is highly likely that taxes will need to increase, at least temporarily, to fund at least



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part of the cost and that is likely to have an adverse impact on private demand, which has been anaemic to begin with.

While Japan is the world's third largest economy, the global recovery has not depended on Japan for its momentum – the contrary is true. Japan's recovery has been highly export dependant. As Capital Economics puts it, Japan has been a passenger in the global recovery and not the main driver. The world is still a highly uncertain place, and there were ample issues to worry about prior to the quake and tsunami (peripheral Europe, the Middle East etc.). In saying this, the world economy is perhaps better able to withstand the kind of shocks currently being experienced than it was two years ago.

For Australia, Japan is still a major trading partner – the Australian Bureau of Statistics merchandise trade data show that in 2010 Japan took 19% of Australia's goods exports by value, with resources accounting for the lion's share. The short-term disruption to Japan's industrial activity is likely to curb demand for Australia's exports in the short term, however, the recovery effort is likely to be resource intensive, and provide something of a boost to our exports to Japan over time. At this point, we see no reason to change any medium-term view about the likely performance of the Australian economy or financial markets.

At MLC, our portfolios are extremely well-diversified across asset classes, investment managers, countries, industries, and individual securities. In the event of a catastrophe such as this, diversification is perhaps the only protection available to investors, but nevertheless, portfolios have been adversely affected, although some exposures within portfolios will actually have fared quite well.

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In global equities, Japan accounted for 8.6% of the MSCI All-Country World Index at the end of February 2011. All except one of MLC's global managers have Japanese exposure (Sands Capital being the exception). The overall portfolio, however, is underweight in Japan.

Moreover, MLC's Japanese equity holdings have fared substantially better than the overall Japanese market, reflecting the high quality, and somewhat defensive nature of our holdings. While many of the Japanese companies we invest in will experience disruption to their businesses, it is also important to recognise that many Japanese companies are highly globalised, with production facilities and operations across many countries. The major car companies are an obvious example.

Our global listed real estate portfolios also have Japanese exposure, and some of the Australian REITs we invest in also have assets in Japan. Reports so far suggest that our exposure to the main affected areas is minor.

Australian shares have also fallen in value in recent days, and individual stocks we hold in MLC's Australian shares strategy will have been affected – both adversely and positively – by the events in Japan. Among the insurance stocks we hold, QBE has already announced its exposure to Japan and its share price has suffered somewhat. However, its exposure is modest when viewed in the context of its overall reserves; the impact on MLC's portfolio has been minor. On the other hand, other holdings in the portfolio, such as Bluescope steel has seen its share prices fare relatively well in the aftermath of the quake. In addition, MLC's



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portfolio is significantly underweight resources stocks that have fallen further than the overall market in recent days, and has little or no exposure to the smaller uranium stocks, where prices have plummeted.

Within MLC's debt portfolios, our exposure to Japanese debt securities has been minimal, reflecting the very low yields on offer in the Japanese Government Bond (JGB) market. Our exposure to Japanese corporate securities is virtually non-existent as spreads over JGBs have been way too tight to attract the interest of our managers.

Prior to this disaster a number of investment managers – both those we currently engage and those we do not – have expressed a view that Japanese equities were attractively valued, and even some traditionally cautious, value-oriented managers have noted that they were seeing opportunities in the Japanese market for the first time in many years. The market contains many quality companies with truly global franchises that will survive this disaster, and eventually continue to prosper. Moreover, there is a chance that this crisis will bring about the kind of decisive policy action that could help end Japan's twenty-year long economic malaise. Please forgive the harsh end to this briefing note, but the role of our active managers, is to look through the human tragedy and seek out opportunities that inevitably arise in the wake of disasters, and that is just what they will be doing.

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