

April 2011

Outlook on Japan

Even though the situation in Japan remains fluid, there are a few certainties about the consequences of the earthquake and the tsunami. First, Japan will have to drastically rethink its long-term energy policy. The country had planned to derive about 60% of all its energy needs from nuclear power, up from 33% currently. However, after what happened, we believe there is a very low probability that new reactors will be built in the next decade. Moreover, all of the existing nuclear facilities will have to bear the expense of major additional safety measures. Alternatives to nuclear energy fall into two camps: the traditionally cheap, but environmentally harmful, oil and coal plants, or the more expensive, but environmentally safer, natural gas, solar, and wind power. The probability that solar or wind power can make up for the energy shortfall quickly is very low, therefore some combination of traditional carbon-based power and Liquefied Natural Gas (LNG) will be the more likely solution. We believe the new energy policy will have implications on investment opportunities throughout the entire energy sector.

Second, the Japanese government is committed to a rapid rebuild of the Tohoku region. The Bank of Japan (BOJ) has already flooded the financial system with liquidity and will continue to do so to ensure a proper functioning of the markets and to provide liquidity for the reconstruction. It is likely that political parties will put aside their differences and rapidly agree on a reconstruction plan. The plan budget will likely be between 10 and 20 trillion yen (between \$123 and \$247 billion) and be funded through the issuance of government-backed bonds. Given the emotional sensitivity around the current crisis, in our view, there is little risk of a fall in demand for these bonds, or, of the government's ability to fund its deficits.

Finally, with respect to the real economy, we expect that, in the short-term, a decrease in demand stemming from consumer uncertainty and supply chain bottlenecks will continue. However, once the reconstruction efforts begin, we believe that the Japanese economy should be able to generate strong economic growth. It is also likely that inflation, which we had expected to emerge sometime over the next couple of years, will come sooner than expected and may be higher than generally forecasted. Higher growth with inflation is exactly what is needed to bring the domestic economy out of its deflationary funk, and it will likely be a bullish signal for the stock market.

Japan has a history of having tragic events thrust upon it, either man-made or environmental. One of the unique cultural features of the Japanese people is their ability to deal with a crisis with resilience and a "can do" attitude. Much has been written and said about the stoic resiliency of the Japanese people throughout this disaster. Japan spends extensive amounts of time training its citizens to cooperate, be part of a larger group, and be prepared for unexpected events. The herculean efforts of the Japan Self-Defense Forces (SDF), the fire and police departments, and other groups, in addition to the fact that there was very little looting, theft, or other maladroitness, is something from which we can all learn. Even taking account of the significant problems at the Fukushima nuclear facility, for the nation as a whole, we believe this will prove to have been one of their finest hours.

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