

July 2011

Outlook on Japan

Following the tragic events of March 2011, Japan has begun to recover faster than expected. We believe the country is poised for above-average economic growth, which will be led in part by an increase in domestic infrastructure spending in response to the damage caused by the Tohoku earthquake. Private sector initiatives enacted due to the shortage of power generation have far outpaced the government's response, and in our view, will shape energy trends in the future.

Private sector manufacturers in Japan managed to restore factories back to their operational level far faster than anticipated a mere three months ago, although we believe the swift recovery should not have come as a surprise. The ability of Japan's management-labor partnership to pull together for a common cause is well known, so the sight of workers coming together to dig out from under the damage wrought by the devastating tsunami should have been expected. The contrast between the steady stream of corporations announcing the restart of factories earlier than planned, with the continued failed efforts of politicians to forge a cogent policy for rebuilding Tohoku, could not be more stark.

We believe that Japan is now well-positioned to witness a cyclical period of above-average economic growth. Unlike the lower-magnitude Kobe earthquake, whose damage was relatively localized, the size and scope of the Tohoku earthquake has shocked the nation. Thoughts of rebuilding homes and commercial property to improve earthquake resistance before March 11th are now set to become a reality. There are those who estimate that 30% of all structures in Tokyo would not stand up to an 8.5-magnitude earthquake. Rebuilding the city on such a large scale implies a major boost to aggregate economic activity for the nation as a whole. The Nagoya area faces a similarly high probability of a major earthquake and will likely require a similar response. This is not something that requires government incentives, as we feel that natural economic forces will play a far more significant role. It is already apparent that newer, more earthquake resistant office and apartment buildings are seeing increased demand and improved pricing. The opposite is true of older, less structurally sound buildings. As pricing differentials continue to widen, owners of risky assets will likely have no choice but to reinforce or rebuild their properties to remain competitive. Therefore, we believe that domestic infrastructure-led growth will likely drive Japan's economy for years to come.

Turning our attention to the shortage of clean energy alternatives to nuclear power, it seems that the forces of economic necessity are shaping trends towards decentralized power generation long before the government constructs a sensible policy initiative. Faced with a shortage of power generation, many companies are opting to install their own gas- or diesel-powered cogeneration systems. This is not limited to manufacturing facilities, as demand and rental rates for office buildings with on-site generation capacity have risen due to the need for companies to satisfy business continuity plans. It has become clear that many plans are inadequately structured to deal with a major earthquake, even one as far away as Tohoku. In addition, the private consumer has moved to install solar panels, gas powered fuel cells, LED lighting, and energy efficient appliances out of fear that power shortages may persist for some time. This combination increases the probability of a widespread move towards distributed power generation, and a dismantling of Japan's post-war regional energy monopolies.

These private sector initiatives have progressed farther than the government's response to the tragic events on and subsequent to March 11th. The political infighting has been one of the most disconcerting aftereffects of the crisis, and it appears to be of significant concern to many citizens of Japan. In our view, this has resulted in significant pressure on Japan's current political leaders, and appears (based on media commentary) to focus on the emergence of newer and younger political leaders. Much of this movement for change is being seen among mayors and prefecture governors, where young and energetic politicians are pursuing radical reform. If this movement were to spread to the central government, one could expect a significant political change.

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