

January 2012

Outlook on Japan

A rebound appears to be underway in Sendai, a town of more than one million inhabitants. In the ten months since a 9.2 magnitude earthquake decimated much of the northeast coast of the island of Honshu, Sendai has emerged as the epicenter of the region's economic revival. First, the insurance claims adjusters arrived. Then, manufacturers sent additional staff to restart factories and volunteer organizations established a base of operations in this town. Those who were displaced by the loss of their homes migrated to Sendai, which remained relatively intact. Soon, Sendai faced a shortage of service workers, from hairdressers and dry cleaners to restaurateurs and caregivers. Citizens from as far south as Tokyo discovered fairly quickly that the extension of the *shinkansen*, or Japan's high-speed train system, provided access to Sendai in little more than an hour, making it a convenient location for both work and tourism travel. Although, at present, rural fishing villages continue to cope with debris disposal and grapple with how to rebuild communities ravaged by the tsunami, we believe Sendai has become a beacon of hope and renewal.

Meanwhile, Tokyo is witnessing its own resurgence. The need to reconstruct homes, apartments, and commercial property considered at risk in the event of another major earthquake has sparked a construction boom. Year-end bonuses in the private sector have risen by 3%, the second consecutive annual increase in as many years¹. It has been 21 years since the bursting of the economic bubble, which means that even those individuals who took 30-year loans at the peak of the bubble in order to buy property have repaid enough principal to eliminate their underwater exposure to real estate, so that the balance on their mortgage no longer exceeds the value of the mortgaged real estate. Thanks to the rapid restarting of thermal power stations and a surge in the installation of cogeneration systems (electricity and heat generation) at manufacturing plants and office buildings, we believe the risk of power shortages in the Tokyo area is relatively limited. The year-end shopping season also appeared to be reasonably strong, as department stores reported better sales in 2011 than in 2010. We believe there is a real sense that the Tokyo community, while still deeply traumatized by the earthquake and Fukushima disaster, has decided to embrace the year-end festivities, thus bringing 2011 to a cathartic close.

If the rest of Japan could embrace the can-do optimism shown by their fellow citizens in Tokyo and Sendai, we believe 2012 could prove to be a watershed year for renewed economic vigor. Unfortunately, the prospect of this development is hampered by a number of factors, in our view. Ironically, nuclear energy plants, which caused critical problems as an indirect consequence of the earthquake, are now much needed in order to meet electricity demand in Japan's western region. In Kansai, home of Japan's second largest city, and Kyushu, farther to the south, nuclear energy historically accounted for as much as 50% of total power generation. As nuclear generators have been shut down for regular maintenance, local opposition to this energy source has eliminated the possibility of a rapid restart. Thus, only two of Kansai Electric Power's 11 reactors are in operation, and both are scheduled to be shut down for maintenance by April 2013. Consequently, there is a critical shortage of energy production this winter. The entire region remains under energy consumption restraints and, not surprisingly, the mood is somewhat less festive in this part of Japan.

Another difficult challenge facing the nation is what to do next with the coastal regions, both those affected by the tsunami, as well as those at risk of a large earthquake occurring farther to the south. The central government has passed a number of reconstruction bills, but has yet to develop a comprehensive revitalization plan for the future. Since 20% of all earthquakes worldwide occur in or near Japan, we believe that it is essential that policy reflect the risks to coastal communities. There has also been some concern that the authorities have yet to propose a plan that will gain wide support.

Given the relative strength of private sector finances (both corporate and individual), a resolution to southwestern Japan's energy issues and a proper framework for rebuilding fishing and farming communities on the coast could easily translate into a recovery of substantial proportions nationwide. While we believe it may be unrealistic to expect a comprehensive central government response in the near term, Osaka's

newly elected and extremely popular Mayor Hashimoto may well be the trigger for policy enactment. The mayor has announced his intention to field candidates in the national election if he is unsuccessful in seeking to merge Osaka's city and prefecture bureaucracy. The emergence of a reformist movement that has popular backing may be the catalyst for more profound change, in our view. With the TOPIX at historical lows, we believe it would take only modest improvements to spark a powerful change in market sentiment and, in particular, the performance of domestic-oriented companies.

Notes

1 Source: Nikkei News. As of December 11, 2011.

Important Information

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