

## Japan Update

March 21, 2011

While the human tragedies in Japan are immeasurable and extremely adverse, we do want to provide clients with our latest thinking relating to the economy, the markets and their portfolios. Though it is difficult to predict the impact on the Japanese economy, lost economic growth and steep government costs are expected at least in the near term. We have identified several preliminary economic implications.

- **Economy:** The Japanese economy, the third largest in the world, is expected to experience an initial decline in gross domestic product as business activity is disrupted. However, a mass rebuilding of infrastructure could provide a future source of growth. Meanwhile, money is expected to flow into Japan from insurance claims, financial aid and repatriation of savings and should eventually stimulate domestic consumption as people work to rebuild their lives. Ultimately, everything from household appliances, automobiles and housing will need to be replaced.
- **Currency:** The Bank of Japan (BOJ) has continued to make massive liquidity injections into the financial system to provide monetary support. This injection of liquidity is also aimed at keeping the Japanese yen from rising too much on repatriation flows. Meanwhile, and at the request of Japanese authorities, the Group of Seven (G7) announced a coordinated intervention in the foreign currency markets to prevent the yen from rising further. G7 members hadn't entered the currency markets together since 2000, when they sought to buoy the struggling Euro. A stronger yen threatens to hamper Japan's recovery by curtailing earnings of the country's exporters.
- **Government Debt:** At approximately 200% of GDP, Japan currently has the highest debt of any industrialized nation, and any further borrowing may imperil the country's creditworthiness. To grasp this number better, Japanese government debt is almost equivalent to the U.S. gross domestic product. In January 2011, S&P downgraded the country's debt from AA to AA-, citing fiscal challenges. At the same time, Prime Minister Naoto Kan, who is the country's fourth prime minister in five years, has been unable to pass a budget amid ongoing political gridlock. The Japanese government will now be faced with the daunting task of getting their finances in order.
- **Supply/Demand Disruptions:** Japan is considered a top-tier manufacturer and the crippling effect of the disaster is expected to cause significant supply disruptions as the country is largely viewed as a financial, industrial and technological giant. Capacity is particularly constrained in the automobile, chemicals, semiconductor and electronics sectors. For example, carmakers Honda and Toyota have suspended production and electronics firm Sony temporarily closed plants. These types of events are expected to have a ripple effect across the globe. However, market analysts argue that there appears to be plenty of global capacity to shift around and that Japanese companies could potentially lose out to other global players if this occurs.
- **Electricity/Nuclear reactors:** Japan's electric power supply has been severely damaged, particularly in Eastern Japan. In an effort to prevent supply shortages from causing large-scale blackouts, power companies are calling for electricity conservation and have started rolling blackouts, under which scheduled blackouts take place by area. Meanwhile, workers at a quake-stricken nuclear power plant continue their ongoing struggle to avert a major radiation catastrophe.

At this point the extent of the damage to the Japanese economy has yet to be fully understood and may significantly expand depending on how the nuclear issues unfold. The unfortunate events in Japan, along with political unrest in the Middle East and Northern Africa remind us that markets, at any time, can be impacted by financial and economic crises, as well as natural disasters. This underscores the value of broad portfolio diversification. As always, please feel free to contact any of the professionals at DiMeo Schneider for assistance.

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