

Japan and the Markets



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**Commentary by Drummond Brodeur, Global Strategist
Signature Global Advisors
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I would start with two key observations. First, the situation remains fluid and the full extent and implications cannot be assessed with any degree of precision. Second, the events of the past week are a reminder of how globalization has led to a tremendous increase in both complexity and interconnectedness in the real economies, as well as in financial markets. At Signature, we have built our team to match this evolution and over the past week, all of us, both our macro and global sector specialists, have been working to understand potential outcomes and courses of action.

Macro: global impact

As harsh as it might sound in light of the massive scale of the human tragedy, natural disasters rarely alter the course of the global economy. There may be short-term disruption or redistribution, but the trend tends to remain intact. In our opinion, the global economy was entering the middle stages of a global economic recovery led by capital expenditures and we do not see the momentum behind that trend reversing. Even in Japan, while we expect to see a significant short-term drop in GDP, by the second half of the year reconstruction efforts will start to offset the decline. In terms of Japan's global impact, while Japan is the third-largest economy in the world, it has been stagnating for two decades and is not a significant contributor to global growth. More than any other major economy, Japan, unfortunately, really is an island. There will be some specific supply chain disruptions, there will be an increased import demand for conventional energy sources, such as coal gas and oil, and the global nuclear renaissance will be, at the very least, put on hold pending further review. Beyond these specific situations, the implications for the global economy are expected to be relatively small.

Japan impact

Clearly, the biggest risk facing Japan today is the extent of radiation leakage from the Fukushima nuclear plant. We do not yet know what this is, and much of the market action and press commentary are a reaction to fears of what could happen given the paucity of hard information available. Assuming that the problem is contained and begins to dissipate soon, we can make some still preliminary estimates of the impact. Should the

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situation deteriorate toward a worst-case scenario, then obviously the outcome will also deteriorate.

The earthquake and tsunami hit Japan roughly 200 miles north of Tokyo in a mostly agricultural region, although with some industry and logistical infrastructure. Overall, the region represents only about 6% of Japan's GDP. The more significant impact on Japan will come from the disruption to the electricity infrastructure from the damage to the Fukushima nuclear plant. Japan generates roughly 30% of its power from nuclear and the shutdown of much of this fleet has led to power shortages in Japan beyond just the quake impacted region, including the Tokyo region. As a result, closer to 50% of Japan's economy is facing power shortages. Should this prove to be temporary, as other sources come back on line, then there will be limited impact to the broader economy beyond the current couple of months. More extended shortages could have a more severe impact, particularly on manufacturing industries that require continuous and stable power supplies such as semiconductors. However, even here we would expect many such facilities to have access to back-up generators.

Markets: equities

Global equity markets were generally thought to be overbought and ready for a modest consolidation or pullback. Having rallied roughly 25% since September, a 5-10% correction is not unusual and the events of the past week have provided the catalyst for just that. In Japan, the market was down by over 20% at one point, an over-reaction in our opinion. Interestingly, with the decline, the Japanese market's P/E level was lower than the global level for the first time in over 30 years. We remain comfortable with current market levels and valuations and have been increasing our equity exposure over the past week as we reduced our cash positions modestly.

Yen

As expected, the initial reaction of the yen was to strengthen, but with levels stronger than 80 yen to the dollar, the Bank of Japan stepped in to stabilize the market in a coordinated action with global central banks. The purpose of such intervention is to provide stability in the currency markets, not to fundamentally alter its level. With the information vacuum surrounding the radiation leak, the yen market was susceptible to panic and speculation that was not in anyone's fundamental interest. It was the first example of coordinated intervention in currency markets in over a decade and does not represent any change in policy stance, but is recognition that extraordinary events can require extraordinary policy reactions.

In terms of short-term liquidity, the Bank of Japan continues to pump significant amounts of liquidity into the financial system and has expanded its asset buying program that

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allows it to purchase REITs and equity-related securities. In the near term, it is doing its bit to maintain stability in financial markets during the crisis. How the bank and the politicians deal with the longer-term fiscal needs of a reconstruction process at a time of record debt and deficits will be a critical issue in the coming year. It cannot be answered at this point in time, but will be an issue that Signature will be watching.

Longer-term impact

In the longer term, I fear this will be another setback for Japan unless it prompts a significant shift in public and political attitudes towards how the country operates. Leaving aside the funding implications for the government, the events of the past week will reduce the attractiveness of Japan as a location for foreign companies. More operations of global firms are likely to shift out of Tokyo and toward Hong Kong or Singapore as regional headquarters. Many manufacturers will also look to ensure a more geographically diversified supply chain for key components. This will include either alternative suppliers, or require Japanese suppliers to move additional operations offshore, thereby shifting capital and expansion spending into other geographies. For a nation already very insular and with terrible demographics and fiscal challenges, such events could leave Japan lagging ever further behind as a globally significant economy. These are obviously long-term issues but they impact the core competitiveness of any country.

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