

IPS View: Japan

Following the appalling tragedy that has engulfed Japan over the past week, we felt it appropriate to issue the following short note from our CIO on our early-stage opinion of its economic and market impact. Needless to say, our thoughts are with all those affected.

Friday's 9.0 magnitude earthquake was the strongest recorded in Japan's history. Large aftershocks continue with at least 20 greater than 6.0 in magnitude. Modelling firm AIR estimate insured property loss to be between \$15bn to \$35bn. This compares to \$7bn for the Kobe earthquake and \$35bn for the 1923 Great Kanto earthquake (these costs are estimated at today's present value).

The earthquake has also damaged the Fukushima nuclear plant, where engineers continue to struggle to control radiation leaks. This has led to the closure of several Japanese nuclear power plants and resulted in rolling electricity blackouts across Japan which are likely to continue in the near term and will clearly have both an economic and human toll.

The earthquake hit at a time when markets were already selling off after rising 30% (for the S&P 500) from their August 2010 lows. This shock and the ensuing nuclear crisis led to a severe sell-off on Monday and Tuesday. The Topix index of Japanese equities fell over -20% in two days, compared to a -22% fall in six months after the Kobe quake. More broadly, as of Tuesday's close, Germany's DAX and the FTSE 100 were down -8.6% and -7.6% respectively for the month of March to date.

It is worth remembering, however, that natural disasters rarely change a country's natural growth path. Economists currently estimate the likely cost to be around 3% of GDP for Japan. The impact on other countries growth will be much more limited. As an example, exports to Japan make up less than 5% of total global exports, and their economy accounts for 12.7% of global GDP. Much of the Japanese economy is export driven and therefore should remain strong (other than in areas directly affected by the quake and tsunami).

One consideration is however the Japanese Yen, which is currently very strong. Post Kobe, the Yen strengthened +20%, which at present levels would be harmful to the export-orientated economy and so affirmative action by the Bank of Japan is needed in order to limit strength in the near term as Japanese corporates and individuals repatriate capital.

Overnight the Topix bounced +6.6%. IPS client portfolios generally have a 5% allocation to Japan and so the direct impact is limited. As markets were already nervous after a large run up we expect volatility to continue in the near term – particularly as long as uncertainty over Fukushima continues. We do not currently think, however, that the long term impact of the earthquake will be significant for global growth. On this basis, prices just got cheaper, particularly in Japan.