

A Perspective on Japan

In the initial aftermath of Japan's devastating earthquake and tsunami, the scale of human tragedy and loss and the preservation of life remain the world's primary focus. The barrage of images is a constant reminder of the fragility of human life and infrastructure in the face of natural disasters. Our thoughts extend to all who have been personally impacted by this tragedy.

The 9.0 magnitude earthquake that rocked Japan on Friday afternoon was the largest experienced by Japan and the fifth largest in the world since 1900; the loss of life is expected to climb above 10,000; the country continues to experience significant aftershocks; 400,000 people are reportedly homeless; basic supplies in the areas affected are scarce; rolling energy blackouts are in place across the country; and production has been halted by numerous Japanese companies with facilities near the greatest areas of impact. The largest unknown at the moment continues to be the significant levels of damage sustained by Japan's nuclear power facilities and the rising risk of a nuclear disaster.

While it remains far too early to estimate the lasting impact this event will have on the Japanese people and their economy, Japan is perhaps one of the best-situated countries to deal with large scale devastation of this type. Japan's location in the Pacific "rim of fire," a concentrated area of seismic activity, means that its strict building codes and earthquake preparedness undoubtedly helped prevent further devastation. Additionally, wealthy nations, like Japan, typically suffer far less as a result of natural disasters, both in terms of human life and lasting economic damage, than their less wealthy counterparts.

Although the January 1995 Kobe earthquake was far smaller in magnitude, it does provide some important reference points to gauge how Japan might recover from the Sendai quake and tsunami. While Kobe was an industrial center, the areas impacted by last week's events are largely agricultural and are therefore not nearly as strategically important to the Japanese economy, representing just 7% of Japan's GDP versus nearly double that amount for Kobe. And, despite the devastation after the Kobe earthquake, industrial production fell by just 2.6% in January 1995, and then quickly rebounded in subsequent months.

On Monday, in a swift bid to stabilize the markets, the Bank of Japan pumped 7 trillion yen into the financial system and doubled their asset purchase program to 10 trillion yen. On Tuesday the BOJ injected an additional 8 trillion yen into the system, bringing the total infusion to a record 15 trillion yen. The government is also expected to announce a supplementary budget of 1-2% of GDP to aid with reconstruction. Despite the infusion of liquidity and policy support, the Nikkei has dropped precipitously, falling 10.6% on Tuesday on the heels of a 6.2% decline on Monday and 1.7% decline immediately after the earthquake on Friday.

Market Impact

Prior to Friday's events, we had been transitioning towards an overweight position in Japan in our Global and International portfolios due largely to attractive company valuations. Most portfolios, however, are currently within 1-3% of the benchmark weight for Japan so the active allocation impact has been, in most cases, modest.

While the Japanese markets are down sharply, there are companies that are likely to be strategic beneficiaries over the longer term. On Monday, some Industrials and Materials stocks, such as cement makers and construction firms, benefited as they are expected to be exposed to reconstruction efforts. By contrast, IT and Energy companies have suffered, especially Energy stocks with exposure to the construction and operation of nuclear power plants and refiners, which lost facilities and equipment in this tragedy. Additionally, a wide variety of smaller cap IT names have been hit particularly hard over the last few days on market concerns about disruption to production capabilities either directly from damage to manufacturing plants or indirectly due to supply-chain dependencies and the risk to power supplies.

Global markets have largely acted in sympathy with Japan, with many of the world's major markets ending down for the past few days and continuing to lose ground today. Despite this downward pressure, the relative impact on Monday was negligible for most of BatteryMarch's portfolios without Japanese holdings.



In US and emerging markets, a host of companies including names in the auto, petrochemical, oil refinery and steel industries reacted positively on Monday as supplies from Japan may be significantly curtailed and pricing will likely firm up in the near term. Moreover the Japanese yen has strengthened, which is positive for emerging Asia. On the negative side, it does impact near-term liquidity in the region, but this has been offset by the Bank of Japan's injection of money into the system.

Our strategy of broad portfolio diversification and risk control has been helpful during this period. We are in the process of reviewing each of our holdings to determine where specific opportunities and risks may lie. In general we regard this as an opportunity to purchase selective names, which may be beneficiaries of subsequent recovery and reconstruction efforts, and global companies, which are unlikely to suffer significant long-term competitive impacts but are trading off in sympathy with other names. We will, however, be looking to exit as cleanly as possible from positions that we expect to suffer from long-term strategic impairment.

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