

## JAPAN: TOO EARLY TO TELL

March 16, 2011 by SEI Investment Management Unit

Since March 11, Japan has endured a horrific trifecta, including earthquakes, a tsunami and multiple nuclear reactor failures. The losses associated with this incident in terms of human lives, property damage and economic output are still being tallied. The full scope of the tragedy and the downstream consequences will not be clear for quite some time.

### PHYSICAL DAMAGE AND HUMAN COST

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The third-largest economy in the world was struck by a 9.0 magnitude earthquake on March 10 (and according to the U.S. Geological Survey, it was preceded by a 7.2 magnitude quake in the same area just the day before). The quake caused a tsunami with waves as high as 10 meters (33 feet) that devastated coastal cities and damaged the Fukushima nuclear power plant approximately 200 kilometers (125 miles) north of Tokyo. As a result of damage to cooling systems, three of the plant's reactors are at risk of meltdown and radioactive gases have been released.

While official numbers are still being tallied, the unofficial death toll could be as high as 10,000. The final number won't be known with certainty for some time. Survivors are also facing severe hardship. According to the Japanese government, well over one million households are without power and running water, and there are many thousands of people still awaiting rescue. There are also hundreds of thousands of people in emergency shelters, as well as heating fuel shortages amidst forecasts of freezing temperatures.<sup>1</sup>

### ECONOMIC DAMAGE

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As a result of damages to ports and other infrastructure, including power generation and distribution, we expect that gross domestic product (GDP) will be negatively impacted in the short term—current estimates range from a loss of less than one to over two percent. Rebuilding should help economic activity rebound, and the immediate impacts on fiscal and monetary policy should be add support as well. The catastrophe is likely to help resolve an impasse over the national government's budget, and it also appears to have provided additional impetus to the Bank of Japan's (BoJ, Japan's central bank and the country's equivalent to the U.S. Federal Reserve) planned quantitative easing measures. Long-term GDP could receive a net boost as a result. However, other analysts have pointed out that the long-term costs associated with the damage could be under-estimated, so it remains to be seen whether a net gain or loss of GDP results from the catastrophe over the long term.

Property damage is an obvious concern for owners and insurers. One recent estimate put the value

of insured property in the four most affected prefectures (states) at \$300 billion, so the exposure to insurers and reinsurers is significant. In a development that is reminiscent of the credit market meltdown of 2008, events in Japan seem to have fallen well outside of anything predicted by prevailing risk models.<sup>2</sup> However, other analysts have pointed out that Japanese Earthquake Reinsurance, a government-owned entity, insures a significant portion of private residential property, and that insured losses as a percentage of total losses in Japan have historically run well below the average for earthquakes in other advanced nations.<sup>3</sup> It is interesting to note that while the stocks of some major insurers and reinsurers have been hard-hit following the weekend's news, credit-market spreads are not signaling significant trouble for these companies at the moment. However, a cloud of uncertainty will definitely hang over them for the time being.

## FINANCIAL MARKET IMPACTS

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The catastrophic events in Japan have already impacted the currency, fixed-income, equity and energy markets, and their effects will continue to be felt for some time in those areas. In currency markets, the focus is on the Japanese yen, which has shown strength since Friday as Japan's private sector has been repatriating financial capital in order to fund recovery, and as households and businesses seek to increase their liquidity. This is reminiscent of 1995, when the yen appreciated by roughly 20% following the destructive Hanshin earthquake. Continued yen strengthening would have a negative impact on Japan's exporters and economy. However, unlike 1995, the BoJ was already set to embark on a policy of quantitative easing in which it planned to purchase a variety of financial assets from the private sector in exchange for newly minted yen. This should help to offset higher yen demand to some degree (the exact degree remains to be seen), and should support GDP and asset prices going forward.

The Japanese stock market sold off hard on massive volume in its first day of trading since the earthquake-related events. This, too, is reminiscent of 1995, when the Topix Index<sup>4</sup> fell by over 20% in the week following the earthquake. However, in that episode, the market recovered its losses less than two weeks later. More importantly for today's investors, the Japanese stock market is far cheaper now than it was in 1995. Its price-to-earnings ratio is in the low-to-mid teens today, but was over seventy in 1995, and its current price-to-book ratio is half of what it was then. Japanese equity investors could certainly be in for some tough sledding in the days ahead, but they should be in a much better position than they were in 1995, when the Nikkei 225<sup>5</sup> was twice its current value and many times more expensive relative to assets and earnings.

In fixed income, there has been a mild flight to quality even though nominal Japanese government bond yields were already quite low prior to the crisis, but credit markets have been considerably less volatile than the equity markets. It will be important to watch how corporate and industry credit spreads behave in the coming days and weeks, as markets parse all of the information coming out of Japan.

The events in Japan are also expected to have an impact on commodity markets, but as with currency markets, the outlook is still uncertain. A sharp drop in economic activity should pressure

crude-oil prices lower in the short-term, for example. However, the Fukushima reactor accidents are likely to stoke fears over the safety of nuclear power, which could support oil and natural gas demand in the longer term.

## OUR FUNDS

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Benchmark-relative exposures of SEI's funds to Japan are as follows:

### Exhibit 1: SEI Equity Funds – Benchmark-Relative Exposure to Japan as of 2/28/2011

Equity Fund	Benchmark	Fund	Index	Relative
SIT International Equity Fund	MSCI EAFE	18.90%	21.98%	-3.08%
SIIT World Equity ex-US Fund	MSCI All Country World ex-US	13.65%	15.24%	-1.59%

### Exhibit 2: SEI Fixed Income Funds – Benchmark-Relative Exposure to Japan as of 2/28/2011 <sup>6</sup>

Fixed Income Fund	Benchmark	Fund	Index	Relative
SIT International Fixed Income	Barclays Capital Global Aggregate ex USD (hedged)	19.10%	31.95%	-12.85%

Source: FactSet, SEI

## OUR VIEW

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Short-term volatility in the financial markets is to be expected and will continue until the scope of the disaster and its downstream effects become clearer. Global supply-chain disruption, energy concerns, environmental impact, government action and a host of other factors will shape the situation in the weeks ahead. Longer-term, we do not expect the tragedy in Japan to disrupt the global economic recovery.

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<sup>1</sup> Stuart Biggs, Tsuyoshi Inajima and Aaron Sheldrick, "Japan Battles Nuclear Meltdown as Millions Are Without Power," *Bloomberg Online* March 14, 2011, <<http://www.bloomberg.com/news/print/2011-03-13/japan-tries-to-contain-nuclear-leak-as-earthquake-death-toll-may-top-1-400.html>>, accessed on March 14, 2011.

<sup>2</sup> Ben Berkowitz, "Unexpected Nature" of Japan Quake Complicates Insured Loss Estimates," *Claims Journal Online*, March 14, 2011, <<http://www.claimsjournal.com/news/international/2011/03/14/180791.htm>>, accessed on March 14, 2011.

<sup>3</sup> Birgit Roper-Gruner and Emmanuelle Cales, "Munich RE: Sailing hard into the wind" Societe Generale Cross Asset Research, March 14, 2011.

<sup>4</sup> The TOPIX Index is a free-float adjusted market capitalization weighted index. It is composed of all companies in the First Section of the Tokyo Stock Exchange, currently comprising over 1,600 stocks.

<sup>5</sup> The Nikkei 225 Index is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

<sup>6</sup> Fund and benchmark weights include currency and currency hedge positions. This explains negative fund and benchmark weights.

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