

Principal Global Investors Market Bulletin

Update on Japan

On March 11, the nation of Japan was struck by what has now been classified a magnitude 9.0 earthquake at approximately 2:46 p.m. local time. The quake, which unleashed 1,000 times the energy of the 2010 earthquake in Haiti, spawned a 30-foot-tall tsunami that devastated Japan's coastal regions. There have been hundreds of aftershocks, some of which are larger than February's earthquake in New Zealand. At Principal Global Investors, our thoughts are with all those affected by this disaster, which exacts not only a heavy human toll, but also an economic one.

Effects of the earthquake

The tremor in Japan – one of the world's five most powerful recorded earthquakes – was centered some 100 miles off the country's northeast coast and struck near the end of the trading day for the Tokyo Stock Exchange. On the market's first two full days of trading since the event, the Nikkei followed a 6.2% loss on Monday with another 10.6% drop on Tuesday. To put that figure in perspective, after the 1995 Kobe earthquake, the Nikkei fell a little over 8% in the week following; however, the losses were quickly reversed and equity indices reverted to trends in place before the disaster.

Whatever the final toll, the current devastation in Japan is probably less because of the huge efforts Japan put into earthquake preparedness following the Kobe tremor. While this is one of the world's worst earthquakes, it happened in the world's most prepared country.

Current estimates are that the disaster will decrease Japan's GDP by approximately 1%; however, damage to the energy infrastructure is of more dire consequence. Not only did the quake damage the cooling systems at one of the nation's nuclear power plants, but it is also forcing widespread power outages, affecting much of the country. Nuclear plants generate 30% of Japan's electricity, and approximately 30% of that generating capacity has been affected in some way.

Currently, the Tokyo Electric Power Company (TEPCO) plans a 25% cut in power supply to the Kanto region (where Tokyo is located). This could potentially affect up to 30% of GDP. In addition, the government has asked large companies to limit power consumption, which has caused the closure of a number of production plants both inside and outside the affected areas. Government officials met with the Japan Federation of Economic Organization and the Japan Chamber of Commerce to discuss how businesses can reduce their electricity needs; however, to avoid unexpected power outages, TEPCO has implemented three-hour blackouts that will alternate through the company's five areas. It is uncertain how long Japan's power capacity will be diminished, but TEPCO is set to publish a schedule that will allow companies and individuals to plan for blackouts.

Since Japan is one of the developed world's most indebted countries based on the amount of government debt that has been issued in an effort to stimulate a sluggish economy, some worry about the disaster's impact on Japan's sovereign debt rating and potential increases in borrowing costs. However, Japan enjoys one of the highest private sector savings rates of any developed nation and has an enormous ability to raise capital internally when necessary. While the rebuilding effort will take time, there is confidence in the country's ability to fund and coordinate the process. Consequently, as of the time of

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printing, the three major credit-rating agencies have either affirmed Japan's current rating or stated that they saw limited ratings implications.

Central bank response

The Bank of Japan (BoJ) also jumped into action quickly, announcing that it stands ready to provide whatever liquidity the financial markets need to remain stable. On Monday, March 14, the central bank held an emergency meeting and issued an announcement that formalized their policy response. First, the BoJ unanimously voted to keep the overnight call rate "at around 0 to 0.1 percent" to help ensure financial market liquidity. Second, the central bank agreed to expand its Asset Purchase Program in an effort to combat increases in risk aversion and decreases in market sentiment. The facility will expand by 5 trillion yen to 40 trillion yen and will comprise commercial paper, corporate bonds, Japanese government bonds (JGB), exchange-traded funds, and Japanese REITs (real estate investment trusts).

Sector impact

Several sectors will feel the brunt of the financial impact of the earthquake. While estimates of damage top \$100 billion, global insurers will bear only a portion of that amount. Earthquake insurance is expensive for both Japanese homeowners and businesses, so coverage is not widespread. In the Kobe earthquake, economic damages were around \$100 billion, but only about \$3 billion of that amount was insured. For the current disaster, initial estimates place the total for insurance claims around \$10 billion to \$25 billion; still, this will most likely be one of the most expensive quakes in history for insurance companies.

The quake also took its toll on Japanese manufacturers, which has far-reaching effects for global supply chains. Dozens of semiconductor factories were affected by the quake, causing potential repercussions for the consumer electronics industry. Some of the most extensive damage was to auto companies, with Honda, Toyota, and Nissan all reporting damaged factories or suspended operations.

One sector that could see a more lasting negative impact is the nuclear power industry. Attention is currently focused on the stricken Fukushima Daiichi plant, where a reduced

staff continues working to avert potentially devastating radiation leaks and meltdowns. Even if the recovery efforts succeed and further disaster is avoided, safety regulation and oversight will rise – perhaps dramatically – increasing costs and delaying new construction. This event could cause a significant reappraisal of the costs and benefits of nuclear power.

Conclusion and expectations

While the situation in Japan is unpredictable and far from over, Principal Global Investors does have some opinions on the trends that may potentially unfold.

- We lean toward an eventual weaker yen despite repatriations by Japanese insurers to fund insurance claims, which would provide the yen with some support.
- JGB yields fell by two percentage points in Japan over the five months following the 1995 Kobe earthquake. With rates already so low today, JGB yields could dip a few basis points, but we'd expect little other impact.
- The effect on Japanese equities and the economy will be critically dependent on the events in the nuclear power industry. If the nuclear plants are soon stabilized without major radioactive pollution, then we would expect a sharp rebound in stocks from the initial weakness. If, however, there is substantial nuclear contamination, following a meltdown in one or more reactors, the impact on the economy and markets could be severely negative. Either way, we believe it is best to avoid substantial new commitments to Japanese equities for now.
- Economic growth will surely be hit, at least in the short term. Over the longer term, there can be hope that the rebuilding effort will likely provide an important boost to Japan's economy.

The professionals at Principal Global Investors will continue to monitor the unfolding situation in Japan and assess the effects on our clients' portfolios. This includes the employees of our Tokyo office, who are all well and working as close to normally as the situation allows. Should you have any questions about the specifics of your investments or those of your clients, please contact your relationship manager or your client service advisor.

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