

# International Markets Weekly

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## Outlook for Japan, after the earthquake

*It is too early to identify investment opportunities in Japan. We are removing Japan from our short-term (six months or less) attractive list and offer guidance on when to sell. For investors with a horizon beyond six months, we would avoid investing in Japan but are watching for factors that could mark improved investment appeal.*

On March 11, a magnitude 8.9 (Richter scale) earthquake struck approximately 200 kilometers off Japan's northeastern coast. Japan has had serious earthquakes before (especially the 1995 episode) but the latest presents unique risks. In particular, the quake's strength rattled the country's transportation infrastructure, most importantly the nuclear energy sector. Although the reactors shut down after the quake, coolant levels fell, exposing some hot fuel rods. Efforts to stop overheating in the reactors were accompanied by two explosions. The containment structures were intact after the explosions, and radiation levels were still lower than those recorded the weekend immediately after the quake. Uncertainty over the final outcome may continue for some days. This report considers the unfolding tragedy in Japan in light of our investment recommendations.

### Short-term outlook

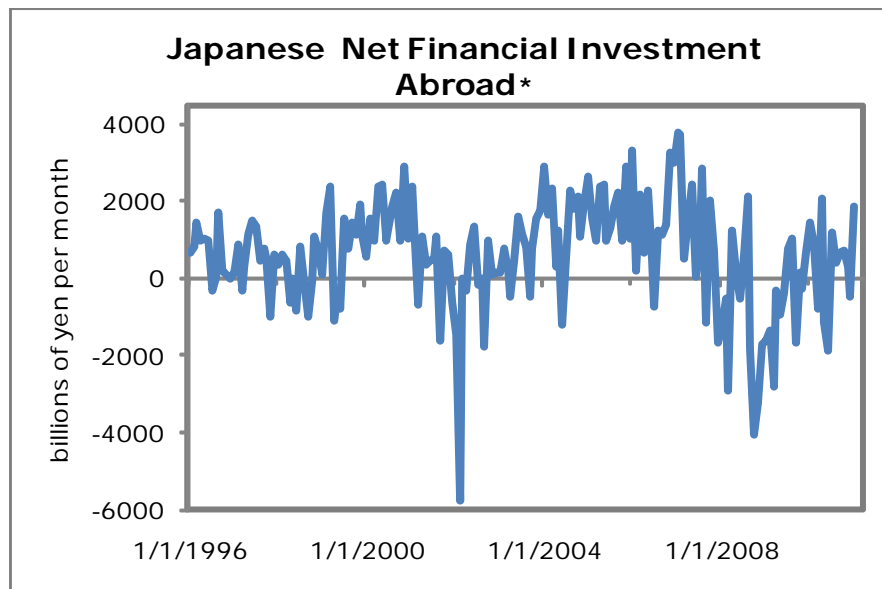
The Japanese economy was already weak and actually contracted in the fourth quarter of last year. One principal concern appears to be interruptions in the supply chain. Plants in the stricken area appeared to avoid catastrophic damage, but many may experience some production delays, especially because of transportation and power disruptions over the coming weeks. For example, damage at some car manufacturing plants was light, but the damage to some parts suppliers was greater. Just as importantly, the systems that transport parts are damaged and may not reopen quickly. Some semiconductor and steel manufacturers are also shuttered as rail and highway transportation, and shipping ports were disrupted and may take weeks to reopen fully. Also, government officials

announced coordinated power outages starting from March 14 to deal with shortages. Serious damage at nuclear reactors in the stricken area could worsen the power shortage.

A large part of the uncertainty is that no one knows the exact damage to the transportation and power infrastructure. Japan's economy appeared to be growing at a modest pace in the first quarter but likely will slow or stall in the coming three to six months. However, as rebuilding gathers momentum, later this year, the economy could return to sustainable growth in the final three or four months of the year.

Responding to the scope of the uncertainty, Japanese equities sold off sharply in the first full trading day after the disaster. Considering the selloff and the questions about Japan, there are several recommendations for investors with a short-term horizon of three to six months.

Regarding the yen: We do not see an attractive opportunity to add yen exposure. The earthquake of 1995 did trigger a rising yen as Japanese financial companies sold international investments and repatriated funds for rebuilding. A repeat seems unlikely this time, in part because the Bank of Japan has been active in expanding its balance sheet through securities purchases. This is a program similar in principle to the Federal Reserve's quantitative easing and weakens the currency. In addition, Japanese investors are still skeptical of overseas investment following the 2008 financial crisis and the European debt stress of 2010. The decline in flows overseas from Japan is illustrated in the chart below. We believe these two differences from the 1995 episode should contain the yen's appreciation potential.



Source: Bloomberg/Wells Fargo Advisors

\*Includes equity and bond investment in other countries.

Data sample: monthly, Jan. 1996 through Jan. 2011

Regarding Japanese equities: On balance, the main short-term factors also weigh in against taking equity positions. The earthquake occurred amid a confluence of global concerns. We believe Chinese data should look weaker in the near future, raising new worries about a hard landing for the economy. Also, European bond yields are rising at a time when governments are looking for new lending. Finally, events in the Middle East remain fluid and potentially volatile. The uncertainty in Japan adds another risk that may dissuade international investors from rushing in to find bargains in Japan.

The desire to avoid risks may have helped Japan's equity markets higher in the weeks before the quake. Japan's Nikkei 225 (a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange) advanced 5.1 percent for the year through March 1, largely because Japan is a perceived global risk haven. As of mid-January, we had recommended Japanese equities for investors with short-term horizons. The earthquake forces us to remove Japan from our attractive list, but investors should wait for a bounce in equity prices to sell. The Nikkei's 6.18 percent loss on March 14 seems to be an excessive reaction based on the uncertainty and may leave little room for better-than-expected outcomes. We believe an oversold rebound is likely and would eliminate short-term positions on that bounce.

Regarding commodities: The quake's immediate implication is for lower prices on some raw commodities. Japanese refineries and smelters were shut down by the quake and the subsequent power loss, and these outcomes destroy crude oil demand and soften prices. However, the loss of refinery capacity should support gasoline prices even though these already appeared overextended due to the unrest in the Middle East. We believe the dominant theme in the coming weeks will be international risk aversion, and consequently we reiterate our recommendation for agricultural commodities and precious metals in the short-term.

### Long-term outlook for Japan

For the long term, the earthquake probably will aggravate two of Japan's chronic problems. First, the quake diverts savings from future spending to current spending to rebuild the infrastructure. If Japan had a relatively young population, there might be time to rebuild the savings before retirement, but Japan's population is aging faster than the world's (35 percent of the population exceeds 64 years in age, compared with 19 percent in the United States and 12 percent for the world) and has little time to rebuild the wealth. Thus, we believe the disaster should lower Japan's wealth over the coming years.

Second, the earthquake aggravates Japan's long-term government debt problem. Rebuilding the damaged infrastructure could cost hundreds of billions of dollars. However, at nearly 200 percent of the size of national output, Japan's government debt is the highest in the developed countries. Japan's debt is overwhelmingly held domestically, but those savers increasingly may be looking to retire and sell debt, which threatens to shrink the government's funding source and heightens the need to reduce the national debt. The political climate in Japan has failed for at least 10 years to address this potential future crisis.

Taking these two problems together, a decline in wealth could complicate the task of paying down Japan's future debt service and could create more pressure for falling prices. Servicing a larger debt from an aging base of taxpayers should require tax hikes at some point. As people find themselves paying higher taxes out of reduced savings, they could find themselves able to afford less spending, which could depress prices and aggravate Japan's 15-year deflation problem.

### Factors to watch

It is too soon to know the extent of the damage to Japan's infrastructure and the time needed for the

economy to rebound. Without more information, it is also difficult to know which sectors may recover most quickly. In the coming weeks, two keys will be how quickly the reactor problem is resolved and how quickly Japan's broken supply chains are repaired. In particular, we are watching for auto, steel and semiconductor factories to resume production.

Over a longer investment horizon, the aging population is expected to remain a negative factor, but an improving political climate could do much to improve the investment outlook. The feuding between the two main political parties should end and bring comprehensive spending and tax reform, before the long-term debt problem can be solved.

Finally, deflation needs to end and restore a low and healthy inflation rate before businesses have incentive to expand and grow. One aspect of long periods of slight deflation is that people accustom themselves to weak or falling prices. Deflation means a low cost of living for retirees (who constitute more than half the voting population) and a low debt service cost for government officials. Eliminating deflation should be a major step toward improving Japan's economic growth and investment appeal.

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