

Special situation Japan

Earthquake and possible nuclear catastrophe

Relatively relaxed reaction on the European financial markets

Rising turnover; sentiment (leading indicators) will come down from high levels; sectors to be affected at varying degrees; selective approach recommended

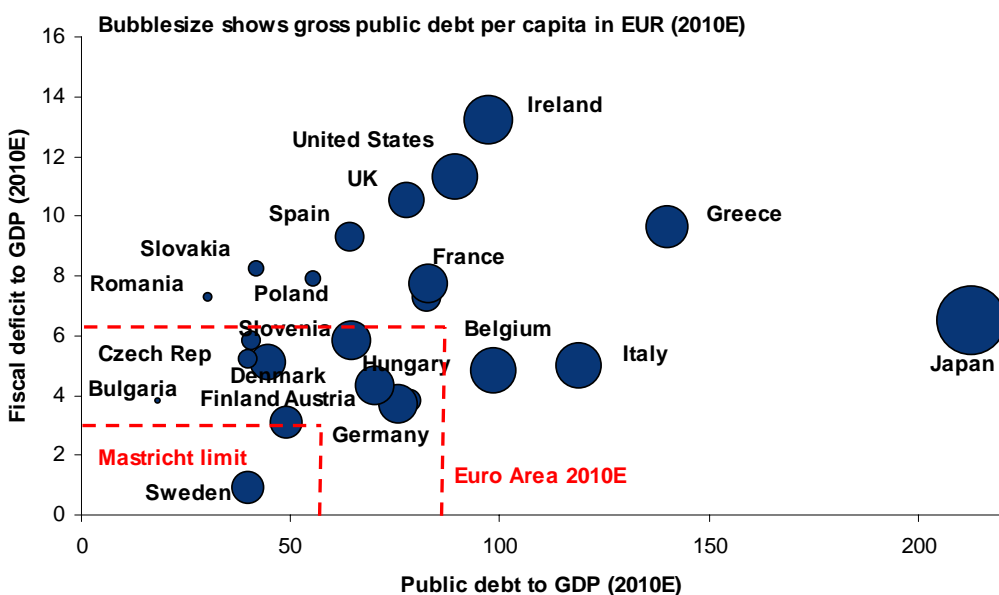
The catastrophe in Japan is a human tragedy, and will cause clearly burdening effects in the short run.

Even though the financial repercussions for the Japanese economy defy estimation at this point in time, we have to analyse the potential effects on the global economy and the financial markets and help investors get their bearings. However, this is being done in an extremely unstable and difficult-to-predict environment (nuclear threat).

Earlier topics take to the sidelines. In view of the dramatic situation in Japan, earlier topics on the financial markets such as the high government debt and the Arab revolution have taken to the sidelines. However, these two issues are closely linked to the current crisis in Japan. 1) Japan is in no comfortable situation as far as its debt is concerned, and 2) the earthquake, and the resulting disruptions in energy and production, will create additional uncertainty on the financial markets in general. The situation will weigh on the economic sentiment, which has been on a gradual rise in the past months. In such a special situation we recommend a selective approach, with our asset allocation for the first quarter 2011 remaining unchanged until further notice. The only change affects Japanese equities (so far neutral, now underweight).

Historically speaking, the debt situation in Japan has been tense. In spite of the comparatively highest government debt, Japan has traditionally managed its leverage quite well (see below for the graph of total debt per capita). The domestic sphere (banks, pension funds, retail investors) accounts for the majority of bond creditors. On top of that Japan holds a widely diversified international bond portfolio (US Treasuries etc.). I.e. the reconstruction of infrastructure could also be ensured by regroupings. Of course the current crisis will add to Japan's government debt.

Gross public debt per capita (in EUR)



Source: Erste Group Research

Economy, interest rates, bonds, and currency

The economic effects on Japan are almost impossible to predict given the little time that has elapsed since the catastrophe. The news flow is contradictory, and no details with regard to the damages caused to the infrastructure are known. But we would attempt to assess the effects on the economy, interest rates, and currency on the basis of some basic aspects.

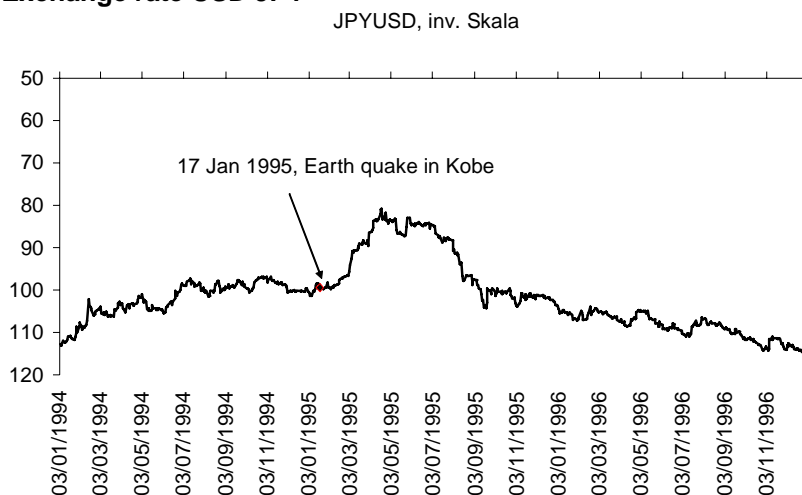
The region that has been hit the most badly by the catastrophe accounts for about 7% of Japanese GDP. How quickly the economy can recover will depend on how swiftly the energy supply can be restored. It is currently impossible to gauge the extent of damage that has been done to the nuclear power plants. The 55 operating reactors in Japan produce about 30% of Japanese electricity demand. In Fukushima 1 a meltdown may be imminent, which would trigger the shutdown of six reactors. Though, in the mid term reconstruction works will give the Japanese GDP a lift.

Outside of Japan the catastrophe should only have a limited impact. Japan runs a trade surplus, which means that overall other countries do not depend on the Japanese economy. Japanese exports will definitely be affected by the damage and will record a decline for the time being. The production shortages should be offset at least in part by the numerous production sites of Japanese companies outside the country. On top of that, other producers should also be able to close potential production gaps.

We therefore expect the global economic effects to remain contained, and they should thus not lead any central banks to change their interest rates. In Japan the interest rates are already close to zero.

The repair of the damages will without a doubt push up the debt of the public sector in Japan further. But the Japanese capital resources are substantial; the country has been a capital exporter for decades. This has led to a situation where Japan has amassed net assets in foreign securities of USD 1,300bn, which represents 24% of Japanese GDP. Therefore it would be possible to cover the financing needs from domestic holdings. However, this could necessitate the withdrawal of Japanese capital from abroad. US Treasuries alone account for USD 900bn worth of assets held in Japan. This would at least cause temporary upward pressure on the yen, much like the earthquake in Kobe. However, the Japanese central bank is likely to intervene on the foreign exchange markets to mitigate this situation as a higher yen would constitute another burden for Japan. Securities and US Treasuries in particular could suffer as a result of the actual or anticipated withdrawal of Japanese capital. But we do not expect massive price declines. The US dollar could generally depreciate as a result of the possible sell-off by Japanese investors.

Exchange rate USD JPY



Source: Bloomberg

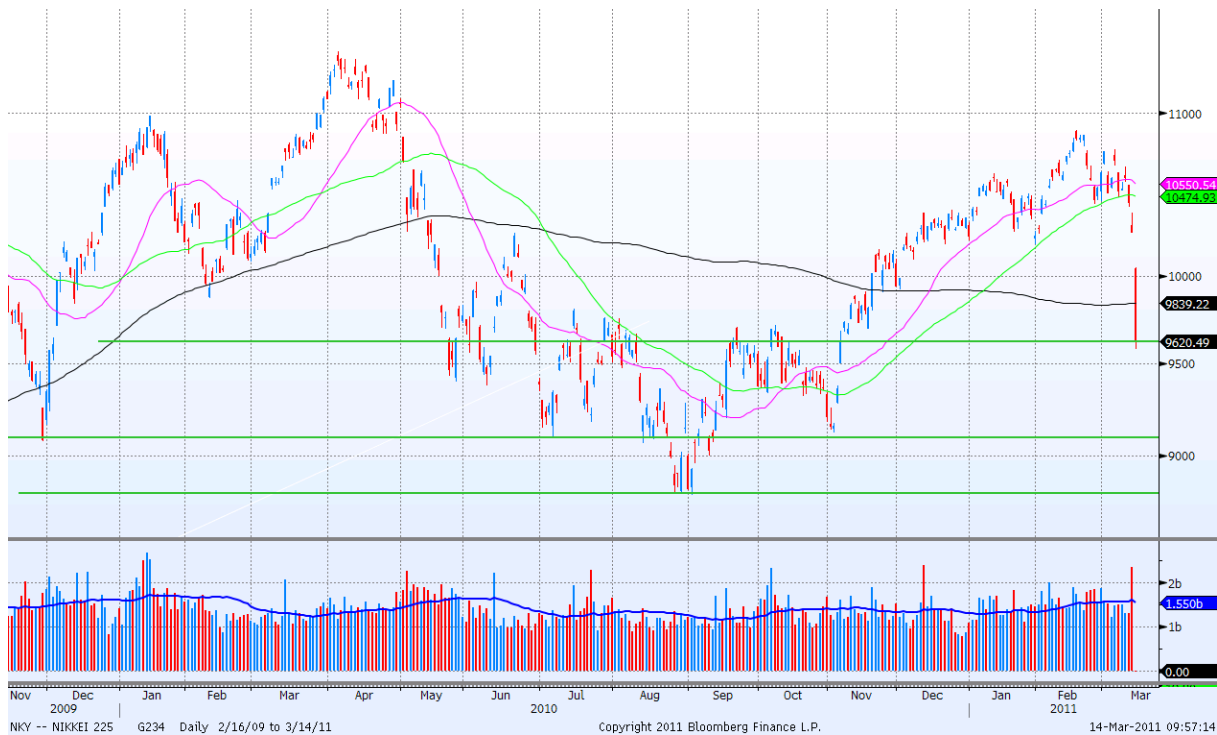
Equity market Japan

We expect the Japanese equity market to remain on the weaker side. – Even if the momentum were to decline gradually. We recommend that investors refrain from investing in a falling market. However, the Japanese equity market seems attractive, having successfully bottomed out. International blue chips such as Sony, Toyota, or Nissan (which are down today by 8 to 20%) should offer long-term potential.

After the earthquake in Kobe 1995, the transportation, insurance, and retail sectors were clear underperformers for the following six months. With regard to the current catastrophe, we expect particularly utilities to join the list of underperformers. The construction sector, on the other hand, should end up among the winners. Daiwa House, Sekisui, and Sumotoma Osaka Cement have recorded clear gains today and should remain among the outperformers.

From a technical perspective the market has stabilised at 9,620 (23.5% Fibonacci retracement). The next support lines of the Nikkei index are at 9,150 and 8,820.

Nikkei 225: Support lines



Quelle: Bloomberg, Erste Group Research

We do not expect any significant effects on the other Asian markets.

Equity markets Europe and USA

The effects of the catastrophe in Japan on the most important indices should on the whole remain low-key for now. Only specific sectors should continue to show relative weakness.

One of the industries that will be affected is the utilities sector, especially in those countries where nuclear power plays a dominant part (among those France, Germany, and also Sweden). The German utilities RWE and EON and the French companies Areva and EDF (Electricite de France) remain under pressure. These shares should remain comparatively weak in the coming quarters. On the other hand, utilities like the Austrian Verbund should clearly benefit from the current situation. Verbund derives a large part of its electricity generation from hydroelectric power and does not operate any nuclear power plants.

In the USA mainly General Electric, and to a certain extent also Exelon, the largest American producer of nuclear power, are affected. Of course as a result of the enormous damage the international insurance sector, and especially re-insurers, will be hard hit. The damage should be in the double-digit billions, which will be spread among numerous insurance companies. At this point in time it is still not known which international insurance companies will be the most severely affected ones. We therefore expect investors to generally underweight this sector in the coming weeks.

Commodities should be less affected. The oil sector could benefit slightly, as could the gold sector as classic "safe haven". At the moment four refineries are closed, with the majority out for longer. Thus the import of processed oil should increase significantly. Coal mining shares should also benefit, whereas the uranium sector should be avoided. In Australia, uranium shares have already recorded a broad sell-off. We expect a similar situation for the large Canadian and US uranium companies.

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