



## Impact of Japanese Events on Markets March 23, 2011

The events in Japan are a horrific tragedy, most importantly in terms of the mounting loss of life, and any comments and discussion of probable economic impact seems literally out of bounds - a little crude actually. Yet there are economic considerations - both for the Japanese and the rest of the world. This horrible event comes at a time when investors are confronting the problems in North Africa and the Middle East. There are also more than lingering considerations for those countries in the Euro-zone still struggling with debt issues. The recovery in the U.S., while going fairly well, is showing some signs of running out of breath. These circumstances serve to raise the question about the viability of the recovery phase of the cycle, and cause investors concern. All very understandable, and while these events will cause problems for markets in the short term, they will not have significant impact over the long term.

Japan, the third largest economic engine in the world, will suffer in the near term, but is capable of recovering from this sort of natural disaster. Japan's economy has worried investors for many years, and their debt is still the largest in the developed world as a percentage of annual output. This might well raise concern about Japan's ability to shoulder the coming costs of reconstruction, but that concern is likely overdone. Though it is true that many Japanese do not carry earthquake insurance, through a somewhat complicated arrangement with the government, much of the cost of rebuilding will be borne by the Japanese government. As pointed out by Floyd Norris of the *New York Times*, Japan owes most of its debt to itself, thus any borrowing for reconstruction will be in yen and so any future borrowing needs can and will be handled by markets.

That said, the recovery will be painful in some quarters, not only for the Japanese, but for some of the rest of the world as well. Again, Japan is a relatively rich country, that continues to be a significant factor in manufacturing - automobiles, semiconductors, shipbuilding, petrochemicals, pharmaceuticals and on and on - and this tragic event will only slow output levels temporarily.

Perhaps the greater question is just how significant the earthquake and tsunami in Japan will slow global growth. At this point, there seems to be fairly widespread agreement that barring a nuclear catastrophe, these events will have only a minimal impact on global growth. The quake and the tsunami will likely impact markets like those in the past: an initial hit to economic activity, followed by rebuilding, followed by even stronger growth longer term. In this case, and without knowing the complete dynamic of the nuclear power issues (Japan is the world's 3<sup>rd</sup> largest producer and consumer of nuclear power), there is worry that the risk premium in energy and oil prices will remain higher for a little longer. As noted, the events in Japan come on the heels of unrest in North Africa and the Middle East, some tightening of economic policies in China, and the more recent events in Libya. All of this adds to levels of uncertainty and that uncertainty will continue to influence capital markets.

While energy markets remain nervous and represent a potential drag, the general package of economic data in the U.S. appears to remain cyclically solid and spending has been increasing. Nominal U.S. retail spending is at a new high, compared with levels seen before the recession, though U.S. employment remains considerably depressed. Don Rissmiller of Strategas Partners points out that while there could be some seasonal noise coming as the Easter holiday approaches, overall spending is now entering the expansion territory of this cycle. Markets around the world seem to be in agreement after the initial shock of these events. Not surprisingly, the Nikkei has sustained the greatest decline. Although still down about 6% YTD, the average was down more and has recovered some of the initial decline. In the U.S. the S&P 500 is now ahead about 2% YTD after being higher, and is still ahead over 11% for the 12 months ended this past week.

In the weeks and months ahead, we will no doubt see some volatile markets and unfortunately, many investors will allow the events of the past few weeks to point them toward the sidelines. We believe that would be a mistake. As usual, investors need to keep all these events in perspective and will be better served by putting cash to work on market dips over the coming months.

Perhaps the greater concern might well be in the intermediate term for investors - the somewhat ominous approach of 2012. Next year is an election year with all that goes with that sort of exercise. Further, lawmakers will be revisiting tax legislation that was kicked down the road by the present Congress, and it is hard to predict what impact the tax legislation may have.

Finally, 2012 will give us ample time to gauge just how the U.S. economy fared in the absence of the monetary and fiscal stimulus (original \$810 billion and QE2) that helped push output for some time.

What markets need for continued growth is the absence of uncertainty. We do not think the tragic Japanese events will have a significant impact beyond the short term; however, 2012 increasingly looks as if it may place some bumps in the road to stable economic growth.

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