

Aftershocks of the March 11 Tohoku earthquake and tsunami for emerging market equities

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The horrific scenes and media reports from Eastern Japan have transfixed the world, and our thoughts are with all those suffering; the almost immeasurable power of nature compounded by the acts of man. We wish for containment, so that the painful process of assessment, healing and recovery can begin. Above all this is a human tragedy.

Immediate implications for an emerging markets equity portfolio

What is happening? The quality of coverage is highly variable and we believe much of it to be ill-informed and misleading. Explosions and evacuations make for good television, but the critical issue is whether the containment vessels housing the nuclear reactors and spent nuclear fuel are damaged or not. At the time of writing this piece, one or two containment vessels could be damaged, leading to the release of radioactive material into the atmosphere. What threat does this pose, to whom and where? The situation is not helped by an absence of trust in the government and in Tokyo Electric Power (TEPCO), the operator of the Fukushima Daiichi nuclear plant, both of whom have a checkered past.

In our global emerging markets portfolios overall we are monitoring the situation. It is as yet too early to make a fundamental assessment on the effects this will have regionally for Asia, LatAm and EMEA, or for individual countries. However, the initial wider implication is that the situation will likely slow the recovery in global growth a little and increase investor risk aversion on most investor's current central case. Slower growth could also have positive implications for global inflation.

The Tohoku area is not a major manufacturing centre, but there are some plants and component suppliers directly affected. Plants that they supply may also be affected leading to shut downs and disruption. Aftershocks are also disrupting activity. Electric power is out and the whole country is likely to suffer from power disruptions for some time to come – these could be the most significant. Nuclear accounts for around 29% of Japan's electric power. TEPCO supplies electricity to 35% of Japan's population in and around Tokyo; 10 of its 14 nuclear plants are out of action and a number of thermal plants are also damaged.

Some oil refineries have been on fire with reports of 20-30% of capacity temporarily taken out, and complex refining spreads have widened to \$10.00 from \$6.30/bbl a week previously. Japan traditionally exports middle distillates (gasoline, jet fuel, diesel), so there may be some opportunity for other refiners and petrochemical producers, and crude prices have also weakened on lower demand from Japan.

The auto industry has announced a number of temporary plant shut downs at Toyota (two plants at Iwate and Miyagi producing 420k units closed), Nissan (all production closed) and Honda (two production and two assembly lines in Saitama closed). Japan produced 9.6m units in 2010 with a 13.1% share of global production; 4.3m units were exported – 42% to North America, 21% to Europe, 18% to Asia/Oceania and 13% to the Middle East. However it is not such a straightforward story as many non-Japanese manufacturers procure parts from Japan. What will the level of disruption be and for how long? It could cut both ways, and then there is the question of components and finished product in the channels. Hyundai Motor obtains more than 95% of components domestically and carries between one and two months inventory. The market for large excavators could also be impacted as both Komatsu and Hitachi have plants that were directly impacted.

In technology there could be an impact in wafer supply to the memory chip producers. Shinetsu supplies wafers to Elpida, Toshiba, Samsung and Hynix, and there are several other passive component suppliers whose shipments could be disrupted. Spot prices for DRAM and NAND could reflect potential supply disruptions and other components such as rechargeable batteries (Sony has shut down its plants) and MLCCs (Murata and TDK were not directly impacted, but power outages could disrupt) could be affected, as could the panel industry.

Nuclear generates around 18% of global electric power from 442 power plants. A further 62 are under construction and many more are planned; suspensions are being announced (China has announced a suspension of all 27 projected reactors) and decommissioning is being brought forward (Germany). It can be assumed that world wide strategic reviews will take place. The nuclear industry will probably stall as the politicians take stock. Noise subsidence and sifting the real issues from the emotional will doubtless take time. Kyoto protocols and carbon emissions can be expected to be turned on their heads, at least temporarily. Memories are short and last year's pariah, deep water oil exploration and extraction, may return to favour, and the appetite for more expensive/subsidised renewables could be boosted, as could demand for carbon emitting coal and LNG. Accelerated decommissioning will require near immediate fuel substitution, however a significant repositioning of energy policy and sources for base and peak power is a much more complex longer term issue.

The Hanshin (Kobe) earthquake of 1995 notoriously brought down the minor British investment bank, Barings, due to unbridled speculation on the Japanese stock market. Volatility can be expected to continue this time around as funds flow, currencies move and bond yields and equity prices whip around unexpectedly. Whilst the cost of reconstruction and recovery in Japan in 2011 will be significant, representing single digit percentage points of GDP, and it will disrupt, it is unlikely to have a lasting financial impact, or indeed to bring down a bank.

The Tokyo stock market capitalization has fallen by significantly more than estimated reconstruction costs. Possibly oversold. Many banks already brought themselves down in the global financial crisis which accounted for myriads of financial institutions and technically a number of countries. They required no assistance from natural forces.

The legacy of the global financial crisis will live with many of the world's tax payers for years. The on-going crisis in European economies, China's economic policy and events unfurling across North Africa and the Middle East are likely to be of more lasting global significance and longer term impact.

The Tohoku earthquake is a painful and tragic fact of life for Japan. With typical stoicism, determination and dignity, the Japanese will cope.