FROM THE CHIEF INVESTMENT STRATEGIST'S *desk*

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Summary

- Lower U.S. dollar as Japanese repatriate capital
- Eventually higher Oil prices and Liquified Natural Gas (LNG), as they replace Nuclear power
- Higher Canadian dollar, based on higher Oil, LNG and lower US dollar. Canadian energy, forestry companies to benefit from rebuilding
- Engineering and heavy equipment companies to benefit from rebuilding
- Lower Japanese earnings in the short term, as plants will be slow to open
- Rebound to be faster than many expect, Japan is a rich economy and can apply significant capital to rebuild
- Fast recovery will be a matter of pride - don't be pessimistic

What the Japanese Quake Means for Stocks

For investors the unexpected earthquake has added more uncertainty to the markets, and this means that we may have to brace ourselves for some confusion in the days and weeks ahead, until we are back to more certain times.

Capital markets are more global now. So, we can expect some financial aftershocks to affect markets all over. Japanese institutions will be liquidating investments to raise cash to help out in the rebuilding of Japan. This selling of securities around the world will cause markets to temporarily be down. A new equilibrium in the markets will be established as they refocus on corporate earnings.

How far this earthquake will affect the actual economy of the rest of the world is much harder to gauge.

Japan is the world's third largest economy. But it doesn't matter quite as much as some may think.

Japan today accounts for a smaller share of the global economy than at any time since the 1970s – 5.8%, according to the IMF, compared to 7.5% a decade ago and more than 9% in the early 1990s.

Japan's stock market, which twenty years ago was the most valuable in the world, today accounts for a smaller share of global equity values than at any time in decades. On the eve of the Kobe earthquake in 1995, it accounted for nearly 30% of world stock market values. Today? Just 7.5%.

The biggest concern however, would be the Debt. Japan's economy has been ailing for 20 years, barely managing to eke out weak growth between slowdowns, saddled by a massive public debt that, at 200 percent of gross domestic product, is the biggest among industrialized nations. Tens of billions of dollars are expected to be needed to rebuild homes, roads and other infrastructure –

requiring public spending that will add to the national debt. The 1995 earthquake in Kobe cost $132 billion and was the world's most expensive natural disaster.

In principle, Japan should easily be able to handle the bill. It is, after all, still a rich country. And even if costs were ten times that of Kobe, they would add only about 7 percentage points to Japan's debt-to-GDP ratio. Japan, unlike the U.S., relies mainly on domestic savers to lend it money, and lately they've been doing that at exceedingly low interest rates.

In 2010, Japanese savers invested $166 billion in other countries, the IMF estimates. Japan is one of the largest buyers of U.S. Treasury bonds. As Japan's government and companies bring home the resources needed to rebuild, those capital flows could wane, pushing down the dollar and increasing U.S. borrowing costs at a time when U.S. government-debt level is also a matter of global concern.

One result of money flowing back to Japan from overseas could be an increase in the value of the Japanese yen, which would have unwelcome effects on Japanese exporters whose production hasn't been disrupted. Analysts expect the Japanese government to intervene if the yen climbs too rapidly. Japanese authorities will not let the yen appreciate with speculative flows.

The Bank of Japan, which vowed "to do its utmost to continue ensuring stability in financial markets," was expected by analysts to pump lots of credit into the financial system to keep it functioning and prevent any unwelcome increase in short-term interest rates, now at zero. Some analysts predict the bank might buy more government bonds if yields start to rise. Another option is to expand previously initiated purchases of private securities or lending directed at particular sectors.

The immediate impacts on Japan are hard to quantify, but relatively easy to sketch out. Production will suffer. Japan's factories play an outsize role in global production-churning out products and parts for other company's goods, ranging from a fifth of the world's semiconductors to large shares of the world's most advanced machine tools and solar panels.

A wide range of industries, from car and steel plants to beer brewers and paper factories, shut down in the wake of the quake and tsunami. How long production is halted depends not just on the direct damage to those plants, but other factors—such as the availability of power needed to run operations. The result could be shortages of key components around the world, though excess industrial capacity in several big developed economies gives the world some manuevering room.

The major factor in oil markets, of course, is what happens next in the Middle East. Japan is the world's No. 3 oil importer, after the U.S. and China; its troubles do nothing to global oil supply. Disruptions in production may limit Japan's near-term demand for energy; oil prices fell in the immediate aftermath of the quake. Over time, though, the shut nuclear plants could lead Japan to increase imports of oil, natural gas and coal. Analysts estimated that replacing all of Japan's nuclear capacity with oil would mean importing 375,000 more barrels a day, on top of the current demand of about 4.25 barrels.

Japan is the world's largest importer of liquefied natural gas, according to the U.S. Energy Information Administration. They will have to import more oil, fuel and natural gas for electricity generation to make up for the shortfall caused by the shutdown of nuclear power plants after the earthquake. This will put upward pressure on global prices in markets already concerned about the availability of energy supplies amid widespread unrest in the Middle East.

When we talk about natural disasters, what is often seen is an initial sharp drop in production... then you tend to have a V-shaped rebound. The Japanese economy will recover, probably faster than many fear. And the economic events of the next few months, or even a year, are less important to the true value of the stock market than investors typically believe.

We remember that Wall Street plummeted in the immediate aftermath of 9/11. We sometimes forget that it quickly rebounded. Asian markets were able to shrug off the economic impact of the 2004 tsunami pretty quickly.

Also, the history of rich countries recovering, albeit painfully, from large natural disasters is encouraging. The resilience of Japan after the 1995 Kobe earthquake is the most obvious - and encouraging - example. "Many, if not most, of the media and others surveyed the broad destruction and predicted it would take as many as 10 years for Kobe to rebuild and for its economy to recover," Purdue University economists wrote in 2000. "In fact, less than 15 months, manufacturing in greater Kobe was 98% of its pre-earthquake trend." After 18 months, all the department stories had reopened. The city's major expressway was result in 21 months. Reconstruction of the port took 26 months."

Research by Ben Inker, chief investment officer at fund firm GMO, found that most of the value of your shares is based on the profits companies are going to earn many years, even decades, into the future. Next quarter's earnings, even next year's earnings, don't matter anywhere near as much as we think. Based on the growth for cars and technology by the emerging markets, the demand for Japanese products will return.

Investors are warned against too much pessimism.

A giant disaster can get Japan to pull together and even provide opportunities for construction and jobs as the recovery gets under way. It's a matter of pride for Japan to show that they will recover fast, and this should lead to a resumption of the recovery.

Nokorimono ni wa fuku ga aru.
Luck exists in the leftovers.

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