Investor Update: Japan & Its Implications

Ronald Albahary, CFA®, Chief Investment Officer
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Earthquakes, tsunamis, food and energy price spikes, near government shutdowns, European sovereign debt downgrades and possibly a third war in the Arab world—how much more can investors, and more importantly, the nascent economic recovery take? The economic ramifications of recent events remain to be seen but investors have taken notice and increased volatility in the financial markets has prevailed over the past few weeks. While we can't provide clarity on the long term impact of the geopolitical shifts we are witnessing, we thought we would take a brief moment to discuss the potential investment implications resulting from the recent events in Japan.

Japan

Our hearts go out to the people of Japan as they prepare themselves for the long and arduous task of recovering from the recent tragic events. With their economy already weakened by twenty years of deflation, Japan, carrying a sovereign debt burden nearing 220% of GDP, will have a difficult time emerging from the trifold disaster (earthquake, tsunami, nuclear meltdown) wreaking havoc on their country. While the Kobe earthquake in 1995 resulted in a V-shaped recovery with the economy never suffering a negative quarter, this time may be different. It is quite probable that some of the hardest hit prefectures will not get rebuilt. Given the estimated $300 billion in infrastructure that may have been wiped out, many businesses may choose not to come back. Many people who have left the northeast region of Japan have also vowed never to return. As such, with 12% of their electricity production shutdown and rolling blackouts in certain parts of the country expected through the end of April, we may see a U-shaped recovery with the bottom part of the U being extended.

Implications to the Global Economy

The Concerns

While the impact on the global economy is unclear, there are a number of areas of concern, including supply chain interruptions and the potential impact on the energy industry, not just in Japan but globally, resulting from the nuclear crisis.

The supply chain issues may affect production and trading in countries such as Australia, Malaysia, and Taiwan in the short term. Even China may suffer as all these countries engage in significant export business to Japan not only because of the disruption in demand but simply due to Sendai's importance as a port for receiving imported goods. In addition many economists have started to reduce their GDP estimates for world and U.S. growth in 2011. With that said, natural disasters, historically, have had only short-term impacts on the local economy and minimal impact on global growth.

Since Japan has been at the vanguard of the movement toward nuclear power, the recent nuclear crisis has been at the center of doubts about the future momentum in that direction. Many countries, such as Germany, have reacted viscerally to the Japanese nuclear situation by stating they will review their strategies for nuclear power development. While China is unlikely to change its long term plans, (it has plans to build 25 reactors), it has announced the suspension of new approvals. Conversely, last week, Russia just announced an agreement to finance and construct two reactors in Belarus with many other Eastern European countries as

well as France reaffirming their commitment to nuclear power. Nevertheless, the negative sentiment promulgated by events in Japan, coupled with the escalating conflict in Libya and continued tensions in Bahrain and Yemen, may continue to cause upward pressure on oil prices and, therefore, may pose threats to the global recovery.

Is There Any Good News?

While Japan's economy is the third largest in the world, its share of the world economy is shrinking. As such Japan's direct impact on the world's global *growth* may be minimal since their contribution to real GDP growth, which has averaged approximately 4.2% per year over the past ten years, has been $1/10^{th}$ of 1% per year. Looking at the economy more broadly, we continue to see relatively strong economic numbers which could mute the effects from Japan and, potentially, help Japan emerge from this crisis. For example, last week economic indicators showed that manufacturing in the Philadelphia region expanded in March at the fastest pace since 1984. In addition the four week average of initial unemployment claims came in at 385,000 (the lowest since the middle of 2008), staying below the important 400,000 mark, the threshold below which economic recoveries are sustainable.

Also, early Friday, the G7 announced their first coordinated intervention in more than 10 years by stating they would help Japan curb the Yen's recent strength. The currency reversed its upward trajectory immediately after the statement was released. This is important as Japan's economy is heavily dependent on exports and a strong Yen will hamper their efforts to increase export growth as a mechanism to emerge from this latest crisis. Other positive implications include:

- Oil producing/exporting countries may continue to benefit from rising oil prices and, they, in turn, may purchase goods from oil importers thereby creating a symbiotic economic feedback loop to sustain global growth.

- Other countries such as Taiwan and South Korea may pick up the slack left by Japan by ramping up their production. U.S. manufacturing may even be a beneficiary of increased production by Japanese firms such as Toyota.

What Does This Mean to Portfolios?

Manager Exposures

Most portfolios have proven to be well-insulated from the events in Japan (via direct exposure), with the impact of these exposures being minimal. Clearly, these events coupled with tensions in the Middle East and higher oil prices may destabilize the global economy in the short term and may cause continued increased market volatility. However, at this point, there does not appear to be any clear themes among managers; some view this as a buying opportunity while others have reduced exposure, but overall most managers have made very few changes to their portfolios. Almost everyone agrees that there will be winners and losers, but it's still too early to determine due to the enormous amount of uncertainty surrounding the global impact and the ongoing nuclear crisis in Japan.

Below are some additional details on the different types of exposure (equity, currency, bonds, etc.) to Japan broken out by asset class, as well as any additional insights that we have received from managers.

- Long-only Equity: Most of our managers have a considerable underweight because of their long term view of the unfavorable demographics, government debt, and corporate governance issues present in Japan. Managers who do have exposure hold most of it in export-oriented companies. Managers believe it is likely that these companies will experience short-term supply and production disruptions but that normal activity should resume quickly and the long term impact from the events should be

minimal. We would also expect our managers to be opportunistic in buying securities that may be extremely undervalued due to the broad selloff in Japanese equities.

- Long/Short Equity: Exposure to Japan is relatively limited in the directional equity space. Japanese equity exposure, either long or short, has been very minimal. A majority of the exposure to Japan comes in the form of derivative plays on Japanese interest rates or foreign exchange that generally expresses a negative view. Here, again, we expect managers to be opportunistic.

- Multi-Strategy Credit/Fund of Funds: Overall exposure to Japan is very small with most managers either net short or holding an allocation between 0–2%. Most of the exposure to Japan is via long/short equity trades or short currency/interest rate positions.

- Opportunistic Credit: One of our international bond managers has approximately 20% exposure to Japanese government bonds, which represents a large underweight vs. the benchmark (33%) due to the large amount of debt outstanding. A majority of the bonds they hold are in the 4-6 year range with some additional exposure to the 10 year and 30 year bonds. However, last week, Japanese bonds rallied about 1%.

Conclusion

As markets continued to soar during last year's fourth quarter and early this year and as volatility dropped, I was starting to think investors had, once again, thrown caution to the wind. When markets rise inexorably, I admit, it is easy to get caught up in optimistic exuberance that every extension of the rally feeds. However, history shows markets are and will always be cyclical i.e., they can't rise forever. As our clients know, Convergent's investment philosophy is based on the cardinal rule of investing—"win by not losing." You see this credo manifest itself in our asset allocation strategy and choice of managers who are focused on the same goals we are: protecting capital and purchasing power and generating stable growth.

Through extensive diversification we attempt to smooth out the volatility inherent in markets especially during uncertain and turbulent times. Basic math dictates that time and patience are our allies and compounding is our friend.

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