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Will Japan's Tragedy Affect the Global Markets?

By now you've seen the heart-wrenching images of the aftermath of the Great Tohoku Earthquake and the resulting tsunami that devastated the northeastern region of Japan's Honshu Island, and, if you're like us, you're closely following the ongoing story of the dire conditions at the Fukushima nuclear power plant, which has suffered a number of explosions and partial meltdowns.

While the scale of the human and environmental aftereffects of the quake are still being strongly felt around the world, we've also been examining the potential economic repercussions, and have put together some observations that should provide a basis for putting the near- and long-term effects into some perspective.

Aftershocks

In the coming days and weeks, a great deal will depend on how the situation at the Fukushima nuclear plant is resolved-- a full meltdown and significant discharge of radioactive material will have serious, lasting effects on the local environment and population, leaving an environmental mess that will be difficult to clean up. One obvious economic side effect of this (already reflected in headlines across the media) is a renewed debate about the use of nuclear power. We've seen GE's stock affected due to its large nuclear power business this week, and similarly, other companies in the nuclear industry could also face fallout. For Japan, the loss of the plant will mean a shortage of electrical energy for years to come (currently the country is faced with controlled, rotating power outages to ration power supply).

The disruption caused by the lack of power and the other quake aftereffects have caused some major Japanese manufacturers to all but cease (or at least curtail) domestic operations, including automakers Toyota, Nissan and Honda. Sony had to shut down eight of its electronic-component factories. Camera, printer and copier-maker Canon saw three of its factories damaged.

A reduction in auto production and sales from manufacturers in Japan could give a boost to sales by U.S. automakers. However, many Japanese automakers produce cars here in

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the States. Also, disruptions to the supply chain for parts for both Japanese and American cars could and would affect both. Again, these uncertainties are what makes it difficult to try to second-guess the impact of the quake and tsunami on the global economy.

The Bank of Japan has already jumped to action (having learned its lesson when, after the 1995 Kobe quake, it waited several months before making any moves), injecting billions of dollars (trillions of yen) into Japanese financial markets and has doubled its commitment to an asset-purchase program similar to what the Fed conducted here in the U.S. (although Japan's program is only about one-tenth the size of the Fed's program). This could see a weakening of the yen, which would help Japan's exporters.

Clean-Up and Recovery

Taking a look at the aftermath of the Kobe earthquake in 1995, we found that after less than 15 months, manufacturing in the region was almost fully back on track, after 18 months, all of the department stores had reopened, the city's major highway was rebuilt after 21 months and after 26 months the port had been reconstructed. That said, Kobe did not have the significant complication of a partial or complete nuclear meltdown in the region, so these figures should be taken with a grain of salt.

In terms of the global economy, Japan should not be considered a driver of economic growth. As the third-largest economy in the world (but only accounting for 8.5% of the world markets by capitalization), Japan takes most of its profits from exports, and disruptions therein may hurt global supply, but not demand. Japan purchased only 4.7% of total U.S. exports in 2010, which represented a mere 0.4% of U.S. GDP. Japan's GDP, whose growth had been muted, had been projected to grow between 1% to 2% in 2011; if it drops to zero, global growth would decline by only 0.1%, to 4.2%. So the threat to the global economy is likely not nearly as severe as some might fear.

Beyond the massive clean-up and reconstruction efforts that will begin in Japan in the coming weeks and months (certainly providing a boost to employment, manufacturing and GDP, not to mention benefiting the multinational companies called upon to help), the near-term disruptions to manufacturing and exports will provide great opportunities for Japan's regional competitors. For example, China's auto and machinery exports should increase, and the country's base metals suppliers should see a boost in prices. Korea, a major exports competitor to Japan, could see a boon to its automotive and electronics industries. Its financial/banking sector has limited Japanese exposure.

Other Disasters

It's worth considering how the markets reacted to other disasters that swept the globe over the last two decades.

Chernobyl's nuclear disaster occurred on 4/26/86. The Dow

was at 1835.57. After a few weeks of roller-coaster declines the market rallied again, and one month later the Dow was at 1823.29, down 0.1%. Three months later the Dow was at 1810.04, down 1.4%. One year later the Dow was at 2235.37, up 21.8%! So, the early days looked awfully dark (though not particularly horrific) but one year later it was as if nothing had happened. (And remember, none of these numbers account for dividends, which would have made the declines even smaller and the gains even larger.)

The aforementioned Kobe earthquake occurred on 1/17/95, leaving destruction in the Japanese industrial heartland. From 3932.34 on 1/16/95 the Dow fell in fractions for a few days, rallied on 2/2 and 2/3 and one month later was at 3953.54.

More recently, remember the gloom-and-doom headlines following the Deepwater Horizon explosion and sinking last April. It wasn't until September that the gusher of oil spewing from the bottom of the Gulf of Mexico was permanently stopped. At the time of the explosion the Dow stood just over 11000. Even after the recent sharp declines at home we remain well above that level.

Many Uncertainties Remain

While this disaster is horrible for the Japanese, and there is still much uncertainty around what is to come, the impact on earnings and interest rates is really not known at all--anyone claiming to have specific insight is, at best, making an educated guess, and at worst, simply looking for a headline.

One certainty that we have at Adviser Investments is that the panic in the Japanese market is going to provide a heck of a buying opportunity for active managers willing to do the hard work necessary to pick the winners from the losers. The managers we invest alongside have, in many cases, been at the helm during past disasters and have the experience necessary to navigate any pitfalls and find the value opportunities that can stem from catastrophe. As the country of Japan rebuilds and moves on in the wake of this tragedy, we are optimistic that our chosen managers' stock picks will also prosper.

We know that you, along with all of us at Adviser Investments send our deepest sympathies to all of the people affected by this natural disaster, and we all remain hopeful that the heroic workers risking exposure are able to safely contain the radioactive material at the Fukushima plant and avert further suffering in the region.

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