

The Impact of the Japanese Tragedy

March 2011

This has been a very sad week as we see images and learn about all of the devastation that has resulted from the earthquake and tsunami in Japan. Our thoughts and prayers go out to all those who have lost their lives and who are suffering in so many different ways.

This tragedy also has a financial impact that will be felt all over the world. We wanted to pass along information from our primary research partner, Litman Gregory, to provide perspective on what impact this disaster may have on the world economy, stock market and your investment strategy.

At the present moment, we do not plan to make any changes to our client portfolios as a result of what has happened in Japan. If our thoughts change, we will communicate any proposed changes at that time.

March 16, 2011

The Impact of the Japanese Tragedy

The earthquake in Japan will have a negative impact on Japan's economic growth in the near term. It will also disrupt operations of many Japanese companies (and even some non-Japanese companies who do business in Japan). Reflecting these concerns, Japan's stock market has declined over 11% since Friday, so much of the short-term impact may already be priced into equities.

Longer term, we believe the earthquake is unlikely to have a material impact on Japan's economic

and stock-market performance, though it is too early to say what the economic cost of this tragedy will be. Japan's last major earthquake, Kobe in 1995, was estimated to cost more than \$110 billion, which the country was able to absorb. Today, Japan is a \$5 trillion economy so even if this disaster proves more costly, the country should be able to absorb the rebuilding expense. Longer term, as history has shown, countries do recover from such disasters, often with economies stimulated by rebuilding damaged infrastructure. The risk is that Japan's already high public debt (over 2x GDP) and large fiscal deficit (of nearly 7% GDP) constrain its ability to fund necessary expenditures. Japan's household savings rates have declined tremendously over the last two decades and, as a result, more of its borrowing will come from foreigners than in the past. With debt servicing costs as a proportion of revenues at over 40%, even at current low interest rates of around 1%, the country is highly susceptible to a fiscal crisis if foreign investors force borrowing rates up. We do not expect the Japan tragedy on its own to have a material short- or long-term impact to global economic or earnings growth, although as we write this the nuclear reactor problem is a wild card with the potential for serious consequences at least shorter term. According to the Bank Credit Analyst, an independent global investment research firm, Japan has contributed about 2% to 3% to global economic growth over the past five years on average, so it seems unlikely that an economic slowdown in Japan could bring about a global recession. That said, the global economy is already fighting what we think are more material headwinds, such as deleveraging from developed countries, higher oil and food prices, monetary tightening from emerging markets, etc., and it is possible that Japan could tip it in the negative direction. If the Japan tragedy does tip the world into a recession, we are well positioned for that given our underweighting to equity risk in our balanced portfolios.

Impact to Our Portfolios

Japan makes up about 15% of a typical international equity index that includes emerging markets. Factoring the different equity weightings across our model portfolios, and taking the index weighting as a starting point, Japan's weighting in our portfolios ranges from less than 1% to 3%.

Most of our international managers are underweighted to Japan, so the true impact of Japan on our portfolios is even less than what this range suggests. Moreover, our Japanese exposure is well diversified across many companies. Of course, global equity markets have also declined in the aftermath of the Japan disaster, but not anywhere near the magnitude of the drop in the Japanese stock market.

We asked several of our international managers how the Japanese companies they own will be impacted by this natural disaster. In general, the response we have gotten is that there will be no material impact to their investment thesis or their estimate of the business' long-term intrinsic value because of the earthquake.

The indirect impact to our portfolios, however, could be more material. As noted above, it is possible that Japan's tragedy tips the world into a slowdown or a recession when combined with many other macroeconomic headwinds we see. Our portfolios, as we've mentioned in our recent commentaries, remain underweighted to equities in light of these risks.

Despite the recent market decline in Japan, we do not see Japanese equities as a tactical investment opportunity at this time. Both the Japanese economy and its stock market, we believe, have to contend with significant fundamental issues in addition to the problems created by the

earthquake and as such we see more downside risks there. Japan continues to fight deflationary forces because of anemic consumer demand, and the current tragedy could depress consumer sentiment further. While the corporate sector-financial and non-financial-has deleveraged to a large degree over the past decade, the public-sector debt has ballooned to dangerous levels and, as we noted above, the country is highly susceptible to a crisis stemming from rising interest rates. These worries are not new and, as a result, over time Japanese equities have declined considerably, but not to a level where we think a tactical overweighting to them is warranted. There are other factors that give us pause. We hear that many Japanese companies remain unfriendly to stockholders. Also, from a purchasing power parity perspective, the yen looks overvalued and may be a headwind to returns for a dollar-based investor.

We will continue to monitor the events in Japan closely and take appropriate portfolio actions based on the risks and opportunities we see. Because we do not believe that Japan's tragedy on its own makes much of an impact on our assessment of global earnings power and, as a result, valuations, if global equity markets decline further, we may use that as an opportunity to add to equity risk.

-Litman/Gregory Research Team

We hope this information has been helpful. As always, if you wish to discuss any aspect of your financial wellbeing in more detail, please do not hesitate to contact us.



Keith Barr, CFP[®], CLU, ChFC
Catherine Gearig, CFP[®], MBA

A Registered Investment Advisor

1055 South Boulevard E. • Suite 230 • Rochester Hills, MI 48307 • (248) 299-4300 • www.lfg-online.com